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Misesian Ownership and Coasian Authority in Hayekian Settings: The Case of the Knowledge Economy — **Nicolai J. Foss**

A Reappraisal of the Say's Law Controversy — **Ivan C. Johnson**

Bastiat's Legacy in Economics — **Jörg Guido Hülsmann**

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MISESIAN OWNERSHIP AND COASIAN AUTHORITY IN HAYEKIAN SETTINGS: THE CASE OF THE KNOWLEDGE ECONOMY

NICOLAI J. FOSS

The present article is taken up with the dynamics of economic organization. In particular, it critically discusses much recent work which has asserted that economic organization—notably, the boundaries of firms, internal organization, and corporate governance—will undergo major transformative changes as a result of the emergence of the so-called "knowledge economy," a term much fancied by business administration and management scholars (Prusak 1997; Neef 1998). An Austrian perspective is a particularly fitting starting point for such an exercise. Surely, Austrian economists—who have always been occupied with analyzing the discovery, dispersion, and use of knowledge—will not be surprised to learn that we live in a knowledge economy. To Austrians, all economies are, in a broad sense, "knowledge economies." This calls for clarification of the concept. However, like its (somewhat overlapping, but nonidentical) "new economy" counterpart in economics, the knowledge economy notion covers many different phenomena,[1] and as in the case of the new economy, the evidence for these phenomena is somewhat scant, perhaps contrary to the impression provided by the considerable media (and some academic) hype. Recent research has established that some of the changes usually packed into the notion, notably

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[1]These include, on the organization side, a shrinking of corporate boundaries and new ways of structuring these, falling firm sizes, and a flattening of internal organization (for example, Mendelson and Pillai 1999; Helper, MacDuffie, and Sabel 2000); increased differentiation of tastes on the demand side (for example, Milgrom and Roberts 1990); acceleration of innovation and technological development on the supply side (D'Aveni 1994); and changes in the composition of labor on the input side (Tomlinson 1999).

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changes in the composition of the labor force (for example, Tomlinson 1999) and some kinds of organizational changes (for example, Ichniowski et al. 1996; Laursen and Foss 2002), appear to be very real ones, while evidence for other kinds of changes is perhaps less convincing.

However, the present article is agnostic on the descriptive accuracy and significance of the *full* notion of the knowledge economy. The aim of the article is to discuss, from an Austrian point of view, economic organization in settings where rapid changes in the external environment necessitate a high degree of organizational decentralization and "empowerment" of employees, where relations to outside knowledge sources (other firms, universities, etc.) are paramount, and where "knowledge assets" account for a large (and increasing) part of value added to production. While such settings have no doubt existed in some industries for a long time, they are not exactly the dominant mode of production that characterizes, say, American business history for a large part of the twentieth century (for example, Chandler 1962; Langlois 2001). However, proponents of the knowledge economy notion assert that these settings are becoming increasingly prevalent in today's business landscape, in the sense that an increasing fraction of firms experiment with decentralizing their internal structures, build relations to external knowledge sources, etc. For the sake of argument, these parts of the knowledge economy notion will be accepted here. The question then is what drives such changes.

In order to understand this, many of those who have addressed economic organization in the knowledge economy have explicitly drawn upon Austrian–more precisely, Hayekian–ideas on the need for decentralization fostered by the presence of dispersed knowledge.[2] They have used such Austrian ideas to argue that hierarchy and planning methods are as problematic inside firms as they have proved to be outside firms; that firms need to harness the ability of markets to utilize, exchange, and build information rapidly in response to changing contingencies; and that extensive delegation of decision rights and the use of high-powered incentives to support this are imperative. Fundamental changes with respect to information technology innovations, internationalization, deregulation, increasing emphasis on shareholder value maximization, changes in the composition of the labor force, etc., have arguably made these Austrian principles of organizational design increasingly pressing. Perhaps not surprisingly, in many recent writings on all this, there is a strong and marked opposition to the central analytical dichotomy between planned firms and unplanned markets that is present not only in

[2]Examples include Ellig (1993, 1997), Ellig and Gable (1993), Cowen and Parker (1997), N. Foss (1999, 2000), Ghoshal, Moran, and Almeida-Costa (1995), Grant (1996), Jensen and Meckling (1992), Jensen and Wruck (1994), Hodgson (1998), and Nonaka and Takeuchi (1995).

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Coase (1937) and Williamson (1996), but also in central Austrian contributions such as Mises (1936, 1944, 1949) and Hayek (1973).[3] Thus, it is argued that only those firms that emulate markets inside their internal organization to the largest possible extent will survive and prosper in the knowledge economy (Cowen and Parker 1997). The "Coasian firm," characterized by well-defined boundaries, authority, etc., will, in contrast, wither.

It is these ideas that the present article critically takes issue with. In particular (but not exclusively), I focus on internal organization issues. Like a number of recent contributors, I discuss the implications for internal organization of the Hayekian notion that the dispersed and subjective character of relevant knowledge is a strongly binding constraint on the use of planned coordination. However, I argue that it does *not* follow that firms should emulate markets as far as possible. In his critique of market socialism, Mises (1949) pointed to the folly of "playing markets," and I draw on his overall argument that bringing coordination mechanisms characteristic of market organization into a planned organization is inherently problematic. I also draw on Mises's related insight that the mixed economy is fundamentally unstable, as well as on his insights on property rights and ownership (Mises 1936, 1949; N. Foss 1994a). Mises argued that the economic institutions of capitalism are strongly complementary in the sense that (unhampered) capitalism is a stable system, consisting of interlocking elements, where changes away from pure capitalism will result in serious inefficiencies. I use this fundamental notion to argue that firms are also systems of complementary elements and that this fact places constraints on the extent to which firms may be made "market-like." In particular, I agree with Mises that "[t]he function of the entrepreneur cannot be separated from the direction of the employment of factors of production for the accomplishment of definite tasks. The entrepreneur controls the factors of production" (Mises 1949, p. 306). The "direction" and "control" undertaken by "the entrepreneur" is qualitatively different from allocation by means of the price mechanism, since it relies on authority that is backed up by the entrepreneur's ownership of the alienable (nonhuman) means of production. In other words, Misesian arguments are used to criticize arguments derived from Hayekian insights that firms should emulate markets to the largest possible extent. In a sense, Misesian arguments resurrect the Austrian and Coasian notion that markets and hierarchies are indeed different mechanisms for resource allocation; hence, the title of this article.[4]

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[3]Cowen and Parker (1997) and Matthews (1998) are particularly outspoken critics of the dichotomy.

[4]N. Foss (1994b) argued that in many important respects, the Austrians anticipated ideas that have become prominent in the modern economics of organization. The arguments

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Economic Organization in the Knowledge Economy: Interpreting Recent Arguments

Economic Organization in the Knowledge Economy: Some Recent Arguments

To repeat, the notion of the knowledge economy is used (and accepted) here to cover ongoing changes in the business landscape, such as the increase in the relative numbers of firms experimenting with decentralizing their internal structures (Ichniowski et al. 1996) and building relations to external knowledge sources (Liebeskind et al. 1995; Matusik and Hill 1998), the tendency of knowledge assets to account for an increasing share of value-added and physical assets for a decreasing share, and the changing skill composition of the workforce (Tomlinson 1999). Numerous writers have argued that tasks and activities in the knowledge economy need to be coordinated in a manner that is very different from the management of traditional manufacturing activities (as portrayed in, for example, Chandler 1962). This has profound transforming implications for the authority relation and the internal organization and boundaries of firms. Cowen and Parker (1997, p. 28) explain with respect to internal organization that

> Market changes are moving manufacturing farther and farther away from steady-state, low variety, long-batch production runs, relevant to Taylorist methods, to high variety and small runs. . . . Organizations are adopting new forms of decentralization to cope with the instability, uncertainty, and pace of change of the market-place. . . . In cluster or network working, employees of undifferentiated rank may operate temporarily on a certain task or tasks in teams. The clusters are largely autonomous and engage in decentralized decision-making and planning. . . . They are conducive to individual initiative (intrapreneurship) and faster decision-taking. They facilitate organizational flexibility.

A number of writers also argue that firm *boundaries* will be profoundly affected by the emerging knowledge economy. Specifically, because of the growing importance of being able to access knowledge from multiple sources, knowledge-based networks (Harryson 2000) increasingly become the relevant dimension for understanding the organization of economic activities. Such networks often cut across the legal boundaries of the firm.[5]

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developed here go beyond those in N. Foss (1994b) by putting more stress on Misesian arguments. N. Foss (1993) argued that Coasian insights were largely consistent with an Austrian perspective, contrary to Boudreaux and Holcombe (1989). Klein (1996) is an application of the Misesian calculation argument to the issue of the boundaries of the firm, and Klein and Klein (2001) treat corporate governance issues in a Misesian manner.

[5]The underlying comparative-institutional argument is that networks are particularly useful organizational arrangements for sourcing and transferring knowledge because the costs of pricing knowledge (in a market) or transferring it (in a hierarchy) often exceed the costs of transmitting knowledge within an informal network (Powell 1990, p. 304; Liebeskind et al. 1995, p. 7).

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This increased reliance on knowledge networks tends to erode authority-based definitions of the boundaries of the firm, because *authority* increasingly shifts to expert individuals who control crucial information resources and may not be employees of the firm. As Zucker (1991, p. 164) argues:

> While bureaucratic authority is by definition located within the firm's boundaries, expert authority depends on the information resources available to an individual, and not on the authority of office. Thus, authority may be located within the organization . . . but when an external authority market can provide information that leads to greater effectiveness, then authority tends to migrate into the market.

To the extent that important knowledge assets are increasingly controlled by employees ("knowledge workers") themselves, traditional authority relations are fading into insignificance. This is partly a result of the increased bargaining power on the part of knowledge workers (stemming from the control over critical knowledge assets), and partly a result of the increasingly specialist nature of knowledge work (Hodgson 1998), which makes principals-employers ignorant about (some of) the actions that are open to agents-employees.

The combined effect of all this is to wreck the traditional economist's criterion of what distinguishes market transactions from hierarchical transactions (Zingales 2000). Thus, whether direction by means of order giving (Coase 1937; Simon 1951; Williamson 1985; Demsetz 1991) and backed up by the ownership of alienable assets (Hart and Moore 1990) obtains or not is increasingly *irrelevant* for understanding the organization of economic activities in a knowledge economy (compare Grandori 2001). It is therefore not surprising that a number of writers are quite explicit that the advent of the knowledge economy increasingly questions the relevance of Coasian organizational economics (for example, Boisot 1998; Helper, MacDuffie, and Sabel 2000). Thus, Cowen and Parker (1997, p. 15; emphasis in original) argue that

> firms and markets are not exactly the same, but rather they differ in empirical terms. They refer to different means of organizing economic activity, albeit means that *do not differ substantially in kind*. . . . This . . . view does not seek to find a clear-cut distinction between firms and markets. Rather the difference between the firm and the market as a resource allocator involves what might more usefully be viewed as subtle differences relating to the form of contracting.[6]

It is easy to see that the above arguments go right to the heart of the crucial and perennial issues in the theory of economic organization. However, before it is possible to provide a response, it is necessary to understand on what

[6]This quotation echoes earlier statements by Alchian and Demsetz (1972) and Cheung (1983), reinforced by Hayekian considerations.

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basis one may put forward such arguments. Austrian economics is a particularly fitting starting point for such an exercise.

Economic Organization in Hayekian Settings

It is no coincidence that so many of those who write on economic organization in the emerging knowledge economy cite Hayek's work, particularly his 1945 paper, "The Use of Knowledge in Society"; indeed, much of what these writers are up to may be understood as an attempt to examine the implications of that particular paper for the theory of the firm (see, for example, Ghoshal, Moran, and Costa-Almeida 1995; Nonaka and Takeuchi 1995). In particular, writers inspired by Austrian economics have analyzed the implications of the knowledge economy for firm organization in terms of the planning problems posed by Hayekian dispersed knowledge becoming increasingly pressing for firms (Cowen and Parker 1997). Coping with the problem posed by Hayekian distributed knowledge has moved from being a problem for socialist managers and *dirigiste* bureaucrats to also being a problem confronted by managers of (at least large) firms in capitalist economies.

Two key claims (or "stylized facts")—which may both be characterized as Hayekian in spirit—are present in recent work on economic organization in the knowledge economy. *The first claim* is that because of the increased need for firms to be source diverse, specialized knowledge in production, knowledge, as seen from the point of view of a manager, is becoming increasingly dispersed in the sense of Hayek (1948). In other words, when such knowledge is not possessed by any single mind, it is still necessary to somehow mobilize it for the carrying out of a productive task or a number of such tasks.[7] *The second claim* is that because of the increased importance of sourcing specialist knowledge, knowledge assets controlled by individual agents ("knowledge workers") are becoming increasingly important in production (for example, Boisot 1998; Hodgson 1998) in the sense of accounting for a greater part of the value added to goods. In the following, I refer to situations in which these two claims are descriptively adequate as "Hayekian settings."

One possible interpretation of the recent literature on economic organization in the knowledge economy is that as Hayekian settings become increasingly prevalent, traditional authority relations vanish (Zucker 1991; Hodgson 1998); the boundaries of firms blur because of the increasing importance of knowledge networks that transcend those boundaries; and coordination mechanisms (that is, authority, norms, teams, prices, etc.) will increasingly be combined in new, innovative ways—resulting in what is often referred to as "new organizational forms," and substituting for traditional relations of

[7]This argument is made explicitly by, Ghoshal, Moran, and Almeida-Costa (1995), Hodgson (1998), and Coombs and Metcalfe (2000).

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authority. This final claim implies that organizational forms do not cluster in a few rigid, discrete forms, but, on the contrary, that coordination mechanisms are highly malleable (for example, Grandori 1997; Helper, MacDuffie, and Sabel 2000). In particular, firms may adopt coordination mechanisms that we normally think of as characteristic of the market rather than of planned coordination, in particular pricing, entrepreneurial control over resources, and high-powered incentives (Miles et al. 1997). In the following, I interpret and discuss some of these arguments. It is convenient to begin with a discussion of the meaning of authority.

The Hayekian Challenge to Economic Organization

To most economists, Coase's (1937) discussion, supplemented with a later contribution by Simon (1951), still provides the working definition of authority. In Coase (1937, p. 242), the employment contract is explained as

> one whereby the factor, for a certain remuneration (which may be fixed or fluctuating) agrees to obey the directions of an entrepreneur *within certain limits*. The essence of the power is that it should only state the limits to the powers of the entrepreneur. Within these limits, he can therefore direct the other factors of production.

This contractually agreed upon right to "direct the other factors of production" is, of course, authority. Much debate in economics has concerned the sources of authority (for example, Alchian and Demsetz 1972; Cheung 1983; Hart 1995). In other words, why exactly is it that the employee agrees to be directed when human capital cannot be traded?[8] However, in Hayekian settings, other questions–which have been much less discussed–are just as pertinent. Thus, if in Hayekian settings, the employer does not possess full knowledge of the employee's action set (that is, the actions that he can take when uncertainty is involved), or if the employee is better informed than the employer with respect to how certain tasks should (optimally) be carried out, or if employees control knowledge assets that are "within their heads" and which may give them substantial bargaining power, what happens to the Coasian notion of authority as direction? It is easy to conclude that under these circumstances, authority simply is not a workable mechanism for allocating resources (and some writers appear to have explicitly adopted this position, for example, Grandori 1997), for the basic reason that the notion of

[8]Thus, to writers such as Alchian and Demsetz (1972) and Cheung (1983), it is not meaningful to assume that an employer can force an employee to do what the employer wants in the absence of coercion. As Alchian and Demsetz argue, an implication of this view is that the distinction between the authority-based and the price-based modes of allocation emphasized by Coase (1937) is superficial. Note that this "nexus of contracts" position is remarkably close to the position that in a knowledge-based economy, the firm-market boundary is unclear and the notion of authority elusive at best.

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authority seems to assume that a directing employer is at least as knowledgeable about the relevant tasks as the employee being directed.[9]

It has recently been argued, in response to Alchian and Demsetz (1972), that ultimately the source of authority is ownership of assets (Hart 1995). If an employer has the power to deprive a worker of access to assets (to which he may have become specialized), the employer obtains bargaining power that forms the backbone of the authority he can exercise over the employee. At the same time, this provides a theory of the boundaries of the firm, since these may be defined in terms of ownership of assets. The assets that in this line of thought confer authority are alienable assets. However, as numerous writers have emphasized, an important aspect of the knowledge economy is precisely that physical assets are of strongly waning importance (for example, Boisot 1998). Of course, the implication is that ownership over such assets is an increasingly ineffective source of bargaining power and that, therefore, authority must wane as bargaining power increasingly becomes more symmetrically distributed over the owners of knowledge assets. Since the boundaries of the firm are (also) defined in terms of legally recognized ownership to the firm's alienable, primarily physical, assets, and since such assets are of declining economic and commercial importance, it is obvious that the very notion of the firm's boundaries is becoming increasingly fuzzy, and perhaps even irrelevant.

Finally, because authority declines in importance as knowledge becomes distributed and knowledge inputs increase in importance, resort to other coordination mechanisms is necessary. Thus, firms increasingly rely on high-powered incentives, implement employee stock-ownership programs, invest in building "corporate cultures," try to price corporate resources to the largest possible extent, etc. This outcome is the emergence of "new organizational forms." The theoretical implication is that various mechanisms for coordinating resources are combined to a much larger extent than hitherto assumed in, for example, organizational economics, where economic activities are normally assumed to be organized across three discrete governance structures: firms, markets, and hybrids (for example, Williamson 1996).

In sum, arguments can be made that Hayekian settings, where knowledge is distributed and knowledge inputs are more important than physical capital inputs, present real problems for the exercise of authority in firms, make the boundaries of firms blur, and remove many of the constraints on the malleability of coordination mechanisms. The following section discusses the reach of these arguments.

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[9]This does not appear to have been Coase's (1937) position. Simon (1951) is a more likely source for this interpretation of authority. He later (Simon 1991, p. 31) pointed out that authority in organizations "is not used exclusively, or even mainly, to command specific actions. Most often, the command takes the form of a result to be produced . . . or a principle to be applied . . . or goal constraints." This was also the view of authority that Mises (1949) held.

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Authority, Firm Boundaries, and Complementary Coordination Mechanisms in Hayekian Settings

In this section, I assume that Hayekian settings obtain and discuss the implications of such settings for the Coasian themes of authority, the boundaries of the firm, and the combinability of coordination mechanisms. The underlying perspective is Misesian, in the sense that I shall throughout assume the existence of a speculating entrepreneur. The entrepreneur is ultimately in charge of the business venture in the sense that he determines "the general plan for the utilization of resources" (Mises 1949, p. 303), hires the managers and "technicians, that is, people who have the ability and skill to perform definite kinds and quantities of work," determines "the expansion and contraction of the size of the business and its main sections," as well as "the enterprise's financial structure" (p. 307), and acquires ownership of the firm's alienable assets. Nobody denies that in the emerging knowledge economy, there will still be a need for such enterprising agents. On the contrary, many recent writings on the knowledge economy very strongly stress entrepreneurship (for example, Miles et al. 1997). What is being claimed is rather, as we have seen, that the entrepreneur will no longer be able to exercise much authority, that the boundaries of his venture will become ill-defined (if not in a formal, legal sense, then in an economic and commercial one), and that his venture can rely on all sorts of combinations of coordination mechanisms, in particular that he can offer employees incentives that in terms of their strength (that is, the way in which they link effort and rewards-punishment) are very close to the incentives provided under market contracting, effectively mimicking the effects of market pricing. I discuss the three issues of authority, boundaries, and malleability of coordination mechanisms *seriatim*.

Authority in Hayekian Settings

In this section, the strategy is to examine the role of authority in Hayekian settings. Since I later discuss the importance for economic organization of the distinction between physical and knowledge assets, I here only concentrate on the dispersed knowledge aspect of Hayekian settings. One way of doing this is to focus on "hidden knowledge" (Minkler 1993) in relations between a principal (for example, the Misesian entrepreneur) and an agent (for example, a hired manager). That is, it will be assumed that the problem facing a principal is not just that he is uninformed about what state of nature has been revealed or of the realization of the agent's effort (that is, hidden information), as in the usual agency model (Holmström 1979), but that the agent's knowledge is superior to that of the principal with respect to certain production possibilities (that is, hidden knowledge). The principal may be ignorant about some members of the set of possible actions open to the

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agent, or the agent may be better informed than the employer with respect to how certain tasks should (optimally) be carried out, or both. As I shall argue, it is possible to explain the presence of authority in such a setting, in the sense of it being rational to give one agent decisionmaking power over another one. I discuss the rationales for this under the headings of "the need for urgent coordination," "decisive information," "economies of scale in decision making," and "defining incentive systems."

THE NEED FOR URGENT COORDINATION. While Hayek (1948) did much to identify the benefits of the price system in the context of alienable property rights in coping with distributed knowledge and unexpected disturbances, he arguably neglected those situations where efficiency requires that adaptation be "coordinated" rather than "autonomous" (Williamson 1996). Coordinated adaptation or action may be required when actions or activities are complementary (Milgrom and Roberts 1990; K. Foss 2001), when it is important to make *some* urgent choice (possibly highly inefficient), because doing nothing is worse. In such cases, it may be better to have somebody pick a strategy and make everybody play this strategy, if the inefficiencies from picking a bad strategy are smaller than the inefficiencies from delaying a coordinated solution. In the context of a specific model of this trade-off, Bolton and Farrell conclude that "the less important the private information that the planner lacks and the more essential coordination is, the more attractive the central planning solution is" (1990, p. 805). Moreover, the decentralized solution performs poorly if urgency is important. Centralization is assumed to not involve delay and therefore is a good mechanism for dealing with emergencies, a conclusion Bolton and Farrell argue is consistent with the observed tendencies of firms to rely on centralized authority in cases of emergencies.

DECISIVE INFORMATION. Even under distributed knowledge, where the centralized decisionmaker per definition does not possess (at least some) local information, he may in many cases still hold the information that is *decisive*. Loosely, information is (strongly) decisive if–in a setting involving many cooperating individuals–a decision can reasonably be made on the basis of this information without involving other pieces of information (Casson 1994). According to Casson (1994), the extent to which a problem involving the knowledge of several individuals has decisiveness features and the cost at which knowledge can be communicated helps to explain the allocation of decision rights. The general principle is that decision rights will tend to be concentrated in the hands of the individual who has access to the decisive information, and particularly so the more costly it is to communicate this information. This provides a further argument for authority under hidden knowledge. If the knowledge possessed by managers is not decisive, if the knowledge possessed by the entrepreneur is decisive, and if it is costly to communicate the entrepreneur's knowledge, then overall decision rights should

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be concentrated in the hands of the entrepreneur; that is, he should assume ultimate authority in the firm.

ECONOMIES OF SCALE IN DECISION MAKING. Demsetz (1988) argues that economies of scale in managing are a neglected factor in the explanation of the existence of firms and the understanding of authority, but he does not explain the underlying reasoning. However, the relevant economies may relate both to managing the internal relations between agents inside the firm and managing relations to outside agents (customers, suppliers, government agencies). Not only may there be scale economies in such activities; there may also be substantial learning economies. Other agents may be happy to let a central agent incur the effort costs of negotiating, learning about potential suppliers, etc., and compensate him accordingly.

DEFINING INCENTIVE SYSTEMS. It is hard to deny too that Hayekian settings pose special problems for the use of monitoring mechanisms and incentive pay (Minkler 1993; Aghion and Tirole 1997; N. Foss 1999). Minkler (1993, p. 23) argues that "if the worker knows more than the entrepreneur, it is pointless for the entrepreneur to monitor the worker," which implies that to the extent that monitoring is a precondition for the exercise of direction, using the authority mechanism also seems to become "pointless." However, even under hidden knowledge, there may still be a role for authority. For example, even under hidden knowledge, the principal may be able to form conjectures of the financial results that result from the agent's activities, and he can check whether these conjectures are actually confirmed using the control systems of the firm. Both Knight (1921), discussing business judgment, and Mises (1949, p. 303), discussing the entrepreneur delegating responsibilities to managers, clearly allowed for this possibility. Neither of them assumed that entrepreneurs would have full knowledge of their managers' action set; still, they did assume that the entrepreneur can rationally delegate decisions to managers and control these. Hidden knowledge does not imply that subjective performance measurement becomes impossible. In fact, it may be conjectured that the more we depart from simple settings where employees are very easily monitored, and the more complicated the control problem becomes, the more likely it is that the entrepreneur will choose to rely on multiple incentive instruments to influence employee behavior (Holmström and Milgrom 1991). In a dynamic economy, maintaining coherence between such instruments may be a recurrent task. Economies of scale may dictate that this activity be centralized. Moreover, centralization is required to the extent that externalities arise when the instruments are controlled by separate firms and transaction costs hinder the internalization of these externalities. Both arguments point toward the centralization of decision rights.

Thus, the above arguments suggest that it is in fact possible to explain authority in the sense of possessing rights to somehow direct another agent

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in the context of Hayekian settings. Admittedly, authority understood narrowly as a relation in which the employer has superior knowledge and can observe all contingencies that require a response by an employee is not consistent with such settings. But firm organization does not at all necessitate this kind of authority relationship. The very fact that firms exist is prima facie evidence that they can somehow cope with the problems implied by Hayekian settings.[10] In turn, this suggests economists are well advised to scrap the narrow understanding of authority with which they have typically worked.

Delegation as a Response to Hayekian Settings

The reason that firms can thrive even though their internal organization exemplifies Hayekian settings is that they have recourse to delegation.[11] As Mises (1949, p. 303) emphasized, "entrepreneurs are not omnipresent. They cannot themselves attend to the manifold tasks which are incumbent upon them." Mises (p. 305) clearly recognized that in many firms decision rights are allocated by the entrepreneur (and the board of directors) to lower levels, presumably in order to better cope with distributed knowledge, an insight that is not present in Coase (1937). He perceptively recognized that delegation leads to agency problems, but argued that the system of double-entry bookkeeping and other control measures may partly cope with such problems. Mises also understood that delegation of decision rights is circumscribed in an attempt to cope with the control problem that follows from delegation.[12]

In the Misesian scheme, an organizational equilibrium obtains where decision rights are delegated in such a way that the benefits of delegation in terms of better utilizing local knowledge are balanced against the costs of delegation in terms of agency losses (as in Jensen and Meckling 1992). This provides a useful perspective on many of those new organizational forms that are argued to be characteristic of the knowledge economy (see Cowen and Parker 1997), such as team-organization, "molecular forms," and other manifestations of organizational delegation and decentralization: These are prompted by a market-driven pressure to delegate decision rights (for example, to better serve customer preferences) and structure reward schemes in such a way that optimal

[10]Of course, there are also offsetting benefits of firm organization, such as the superior ability of firms to organize transactions characterized by high levels of relation-specific investments (Williamson 1985, 1996; Grossman and Hart 1986; Hart and Moore 1990).

[11]An alternative mechanism is to suppress Hayekian settings as much as possible by discouraging local initiative, indoctrinating employees harshly, and operating with rigid routines and operating procedures. In a dynamic economy, however, this is bound to lead to financial disaster.

[12]For example, the right to use an asset in certain ways may be delegated; however, it is understood that that right does not entail the right to use the asset in the service of a competitor firm.

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trade-offs are reached. Thus, decision rights are delegated inside firms, but they are delegated as means to an end (Hayek 1973), their use is monitored (Jensen and Meckling 1992), and top management reserves ultimate decision rights for itself (Baker, Gibbons, and Murphy 1999).

This underscores the argument made earlier that authority in the sense of direction and centralized decisionmaking–which, as Mises emphasized, does *not* require detailed knowledge about a subordinate's knowledge or available actions–may persist in Hayekian settings. By implication, even in "knowledge-based" firms, there may be a need for centralized coordination. As I shall argue next, when there is such a need, it is often efficient to centralize ownership of alienable assets. In turn, this suggests that centralized coordination is a feature of firms rather than markets.

Ownership and the Boundaries of Firms

So far, not much has been said about what backs up authority, although it has been hinted that ownership may play a key role here. The purpose of the present section is to go more into ownership issues and, therefore, the issue of the boundaries of the firm. The argument that will be critically discussed is that as knowledge assets become relatively more important in production, the boundaries of firms will blur, at least to the extent that these are defined in terms of legally recognized ownership of the firm's alienable assets. The work of Oliver Hart and others (Hart 1995, 1996; Hart and Moore 1990)–called the incomplete-contracts literature–offers a possible approach to this issue. The incomplete-contracts approach is a thoroughly neoclassical approach, not an Austrian one. However, it has some features that make it complementary to a Misesian perspective, notably the emphasis on ownership as backing up authority, the argument that the boundaries of the firm lies where the entrepreneur's ownership of alienable assets stop, and the implication that the entrepreneur assumes his directing role because his inputs to the venture are those that matter the most for the total monetary surplus.

In the Hart approach, two kinds of assets are distinguished, namely alienable (that is, nonhuman) and nonalienable (that is, human) assets. The basic distinction between an independent contractor and an employee, that is, between an inter-firm and an intra-firm transaction, now turns on who owns the alienable assets that an agent (whether independent or employee) utilizes in his work. An independent contractor owns his tools, etc., while an employee does not. The importance of asset ownership derives from the fact that the willingness of an agent to undertake a *noncontractible* investment (say, exertion of effort or investment in human capital), which is specific to the asset, depends on who owns the asset. The parties to a relationship are seen as being in a bargaining situation, each having an outside option. Given this, the division of the surplus from the relationship will depend on who owns the alienable

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assets in the relationship, since the pattern of ownership will influence the parties' outside options.[13] In turn, the expectation of this division feeds back into the investments that the parties are willing to make. Efficiency considerations then suggest that authority (that is, ownership to the alienable assets) should be allocated to the agent who makes the most important (noncontractible) relationship-specific investment.

This kind of reasoning may be utilized to get an understanding of the implications of knowledge assets for the boundaries of the firm. Assume, therefore, a purely "knowledge-based" team, consisting of two agents and two knowledge assets. On this team, the entrepreneur owns a knowledge asset that is "inside his head" (for example, an entrepreneurial idea) and the other agent, the scientist, owns the only other asset in the relationship which we may assume to be a patent. Both assets are necessary to create value in the relationship, and they are (strictly) complementary, so that any asset is of zero value without the other. It is prohibitively costly to communicate the knowledge embodied in the entrepreneurial idea from the entrepreneur to the scientist, so it is effectively nonalienable. Moreover, it is not possible to write a comprehensive contract, governing the use of the assets in all contingencies. Given this, we may ask who should own the (alienable) patent which, in terms of the incomplete-contracts approach, is the same as asking who should own the firm.

In this setting, if the entrepreneur makes an effort investment, that is, elaborates on his idea and creates extra value, the scientist can effect a holdup on the entrepreneur, since the latter needs access to the patent to create value (and the contract is incomplete). Of course, the reverse also holds, so that if the scientist makes an effort investment, makes a spin-off patent, the entrepreneur can holdup the scientist by threatening to withdraw from the relation. One can show (details in Hart and Moore 1990; Brynjolfsson 1994) that because of the externality problem that the hold-up threat creates, every agent invests too little; specifically, each party invests to the point where the marginal cost of effort investment equals one-half of the marginal value (because they are assumed to split the extra surplus fifty-fifty). Suppose now that the entrepreneur owns *both* the patent and the entrepreneurial idea. This will strengthen the entrepreneur's incentives (the scientist cannot hold him up anymore), and it will leave the scientist's incentives unaffected. Rational agents will choose this arrangement.

The conclusion is that it *is* possible to speak of the boundaries of the firm in terms of ownership–even in a situation where all relevant productive assets are knowledge assets. However, this does not yet demonstrate the point made

[13]For example, if the employer owns all the alienable assets, the employee can still quit if he dislikes the employer's orders (as in Alchian and Demsetz 1972), but he cannot take the assets with him, and the employer can ensure that if the employee leaves, somebody else can take over the job.

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earlier, namely that authority and ownership somehow go together. This issue can be addressed, however, by assuming that one of the agents, the entrepreneur, has decisive information (in the sense discussed earlier). While it was argued earlier that it would be rational to give this agent decision rights amounting to authority, should he also be an owner? Consider a bigger "knowledge-based" firm where there is a group of n scientists ($n > 1$) each of whom owns a patent. The entrepreneur, who again comes equipped with a nonalienable entrepreneurial idea, aggregates information from the messages of the scientists and directs their efforts. His knowledge is decisive in the sense that without it, all actions of the other agents produce zero value. The entrepreneur may improve on this decisive knowledge. Each agent needs access to his own patent and to the entrepreneur's direction in order to be productive. Given these assumptions, the holdup problem is still present: Any one of the scientists can hold up the entrepreneur on his investment, leading the entrepreneur to choose inefficient investment levels. However, if the entrepreneur is given ownership to the alienable assets, that is, the patents, the holdup problem disappears. Rational agents will choose this arrangement.

Are Coordination Mechanisms Malleable? A Misesian Perspective

Thus far, it has been argued that it is possible to provide rational reasons for authority, for ownership-based notions of the boundaries of the firm, and for authority and ownership being linked, even in Hayekian settings. This prompts the question of whether there are other necessary "links" between organizational elements. Here it is pertinent to turn once more to Mises's work, in particular his work on political economy and comparative systems.

As Mises (1949, p. 709) explained, there are inherent contradictions involved in "playing market," which we may broadly interpret as the introduction of pricing in the context of hierarchy. With reference to various socialist schemes of his day that tried to preserve some market relations while eliminating capital and financial markets, Mises argued that these schemes would be unworkable. To an important extent this is a matter of the sheer impossibility of rational calculation when asset markets are eliminated. But Mises also placed much emphasis on property rights and ownership issues (particularly Mises 1936). Thus, he was aware that the concentration of ultimate decision-making rights—that is, ownership—in the hands of a central planning board would dilute the incentives of socialist managers. While planning authorities could (and, according to the more "sophisticated" schemes of the day, should) delegate rights to make production and investment decisions to managers, these rights could not be used in a rational manner. First, since managers could not be sure that they would not be overruled by the planning authorities, they were not likely to take a long view, notably in their investment decisions. Moreover, since managers were not the ultimate owners, they were not the full residual claimants of their decisions and, hence, would not

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make efficient decisions. Thus, in addition to his pure calculation argument, Mises also put forward property rights arguments for why the attempt to "play market" under socialism would not be workable.

Firms have the great advantage relative to socialist planning boards in that they may to a much larger extent rely on the prices of outside markets. Thus, the Misesian calculation problem, while helping to explain the sizes of firms (Klein 1996), does not imply that firm organization is "impossible." However, some of the property-rights insights into socialism also apply to firms. In particular, a good deal of recent analytical energies have been devoted to the commitment problems of delegation in firms (for example, Williamson 1985; Miller 1992; Baker, Gibbons, and Murphy 1999). Transaction-cost-economist Oliver Williamson (1996) has referred to these kinds of problems with his concept of the "impossibility of (efficient) selective intervention." The main problem is that incentives are diluted. This is because the option to intervene "can be exercised both for good cause (to support expected net gains) and for bad (to support the subgoals of the intervenor)" (Williamson 1996, pp. 150-51). Promises to only intervene for good cause can never be credible, Williamson argues, because they are not enforceable. Although Williamson may be going too far, a main conclusion in this literature is indeed that credible delegation may be very hard to accomplish, since reneging on a promise to delegate will in many cases be very tempting, and those to whom rights are delegated anticipate this.[14] An immediate implication of this kind of reasoning is that emulating market organization inside firms, by radically decentralizing the firm and allocating far-reaching decision rights to employees may be hard to accomplish in a successful manner. Unlike independent agents in

[14]In a recent treatment, the problem is stated in the following way (see Baker, Gibbons, and Murphy 1999): Assume that a subordinate initiates a project, where a "project" may refer to many different types of decisions or clusters of decisions. Assume further that the manager has information that is necessary to perform an assessment of the project, but that he decides up front to ratify *any* project that the subordinate proposes. Effectively, this amounts to full informal delegation of the rights to initiate and ratify projects—"informal," because the formal right to ratify is still in the hands of the manager and because that right cannot be allocated to the subordinate through a court-enforceable contract (see Williamson 1996). Because the subordinate values being given freedom, this will induce more effort in searching for new projects (Aghion and Tirole 1997). The expected benefits of these increased efforts may overwhelm the expected costs from bad projects that the manager has to ratify. However, the problem is that because the manager has information about the state of a project ("bad" or "good"), he may be tempted to renege on a promise to delegate decision authority, that is, intervene in a "selective" manner. But if he overrules the subordinate, the latter will lose trust in him, holding back on effort. Clearly, in this game a number of equilibria are feasible. The particular equilibrium that emerges will be determined by the discount rate of the manager, the specific trigger strategy followed by the subordinate (for example, will he lose trust in the manager for all future periods if he is overruled?), and how much the manager values his reputation for not reneging relative to the benefits of reneging on a bad project. (For details and extensions, see Baker, Gibbons, and Murphy 1999.)

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markets, corporate employees never possess ultimate decision rights. They are not full owners. This means that those who possess ultimate decision rights can always overrule employees. Thus, there are incentive limits to the extent to which market mechanisms can be applied inside firms, and delegation, while not exactly a rare flower, is certainly a very delicate one.

Other means of introducing market mechanisms inside firms are also problematic, if for somewhat different reasons. Thus, multi-task agency theory suggests that there are quite rational reasons for the "low-powered" incentives one typically observes inside firms (in contrast to the "high-powered" incentives of the marketplace) (Holmström and Milgrom 1991). This is because managers wish employees to undertake multiple tasks, some of which may be very costly to observe and measure, but which may nevertheless be vital to the firm (for example, sharing knowledge with colleagues, handling calling customers in a polite manner, etc.). Providing incentives that are only tied to those tasks that can be measured (at low cost) risks twisting efforts away from the costly-to-measure tasks. These problems would appear to be particularly acute in Hayekian settings, because of dispersed knowledge.

Taken together the reasoning above suggests that coordination mechanisms are not simply combinable in an arbitrary fashion, contrary to the thrust of many recent writings on economic organization in the knowledge economy. Ultimately, this is because authority and ownership will continue to be important in the knowledge economy, as argued earlier. First, it has been argued that there is an inherent tension between ownership and delegated rights. Second, in Hayekian settings, delegation is necessary. Delegation often needs to be backed up by a strengthening of incentives because of the agency problem. However, under multi-tasking, there are limits to how much incentives can be strengthened. Thus, rather than being combinable at will, coordination mechanisms, such as authority, delegation, pricing, etc., tend to cluster in predictable ways. This is an application of sorts on the level of the firm of Mises's demonstration that the various elements that make up the capitalist market economy are complementary ones; one cannot simply take a subset of these away, say, unhampered capital markets, and substitute them with elements that are characteristic of a different system.[15] In a similar manner, concentrated ownership, authority, circumscribed decision rights, and incentives that are less "powered" than those of the marketplace are all complementary elements of a system, namely, the firm, and they will continue to be so, even in the knowledge economy. Thus, Misesian arguments help to demonstrate the continued viability of the "Coasian firm," as against those critics who have argued that it will wither under the impact of the increasing prevalence of Hayekian settings.

[15]See also Milgrom and Roberts (1990) for an important discussion of complementarities.

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Conclusion

The understanding of the dynamics of economic organization, such as what will happen to authority relations, the boundaries of firms, and firms' use of distinct coordination mechanisms, is a task of almost forbidding complexity. Yet, a combination of organizational economics and Austrian insights, primarily represented by the works of Hayek and Mises, provides useful insights. The approach of this article has been to try to distill some key assumptions and propositions that characterize much of this literature, and examine these in the light of organizational economics and Austrian economics.

Thus, it has been argued that much of the recent discussion of economic organization in the knowledge economy may be distilled into a basic assertion that the kind of knowledge that Hayek (1948) talked about represents an increasingly binding constraint on the exercise of authority, makes the boundaries of firms blur, and necessitates the use of multiple coordination instruments to efficiently utilize this knowledge. To the extent that increasingly firm hierarchies do flatten, functions are spun off in an attempt to improve incentives, delegation increases, etc., much of this may be interpreted using insights originally put forward by Hayek, as a number of writers have pointed out already (Ellig 1993; Gable and Ellig 1993; Ghoshal, Moran, and Almeida-Costa 1997; Cowen and Parker 1997; N. Foss 1999).

On the other hand, Austrian insights are useful for not only interpreting recent claims, but also for understanding their reach. In particular, Misesian insights are helpful here, and it may be argued that there is a certain imbalance in the above writings because of their neglect of these insights. Thus, I have argued that Mises's insights in entrepreneurship, property rights, and the complementarity of elements in economic systems are useful ones for claiming a role for authority and the boundaries of firms, as well as for helping to uphold the notion that there are discrete organizational forms (for example, firms, markets, and hybrids), and that coordination mechanisms cannot be combined arbitrarily. This strongly suggests that Austrian economics (still) has an important contribution to make to the study of economic organization; in particular, that important principles of efficient organization design can be derived from Misesian foundations.

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A Reappraisal of the Say's Law Controversy

Ivan C. Johnson

> I hold that this law must be reinstated as the basic economic reality in the light of which all economic thinking is illuminated.
>
> William H. Hutt
> *Keynesianism—Retrospect and Prospect*, 1963, p. 389

Despite the pivotal place that Say's Law of Markets held in the early development of economics, no one with any historical perspective can fail to notice its near total absence from today's textbooks. Even as Keynesian theory fades into oblivion, the myth remains that Keynes somehow "disproved" Say's Law and that it is, therefore, irrelevant to modern economic discussion. On the contrary, it will be argued here that the law still stands as both a convincing condemnation of Keynesian policy prescriptions and an indispensable building block for any macroeconomic theory.

Twice in the history of economics there has been a vigorous debate over Say's Law of Markets. Initially the debate was among the classical economists themselves,[1] where Ricardo's apparent victory over Malthus was later to occasion Keynes's (1936, p. 32) famous lament that Ricardo had "conquered England as completely as the Holy Inquisition conquered Spain." Perhaps more importantly, however, a second debate, often called the "post-Keynesian doctrinal controversy," was started by Oskar Lange's (1942, pp. 49-68) attempt to give mathematical substance to the law. Lange's contribution seems to have given impetus to almost all subsequent discussion of Say's Law, but

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[1]See, among others, Say (1853); Malthus (1951); James Mill (1965); John Stuart Mill (1880 and 1968); Ricardo (1957).

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even though he greatly facilitated discussion of classical monetary theory,[2] it should not be thought that he settled the issue of the law itself. Though Lange never stated that his version of the law came from Keynes, he gave nothing more than a mathematical statement of Keynes's view. Lange (1942, p. 53) quoted Malthus and Ricardo several times, but Say only once (and that quotation was only a paraphrase). Little attention seems to have been paid to the fact that Keynes's statements in no way corresponded to what Say had originally been discussing.

In the *General Theory*, Keynes (1936, p. 18) characterized Say's Law as "supply creates its own demand,"[3] and stated that it was (p. 26) "equivalent to the proposition that there is no obstacle to full employment." This seems universally to have been interpreted to mean that if wages and prices are flexible, there is a tendency for the economy to move toward a full-employment equilibrium. Say's own writing, however, from which this law is supposed to be derived, is about the production, distribution, and consumption of wealth.[4] It does not discuss any "tendency" the economy might have to move toward full employment, nor does it discuss monetary theory beyond a lengthy statement of the advisability of a commodity standard as a bulwark against government intervention. Although Say's book is often described as a popularization of the views of Adam Smith, it contains a much more thorough explanation of the benefits of free markets and private property than Smith was ever able to give. In addition, his discussion of government intervention in the economy is a clear demonstration of the ineffectiveness of fiscal policy as a wealth generator–a demonstration that is actually *precluded* by the assumption commonly used in Lange's neo-Walrasian framework that only *market* transactions be considered.[5]

The Simplest Exchange in Lange's Framework

Lange's framework was given in a well-known algebraic format, but simple numerical examples of market exchanges may be used to show all of the points he made. Assume, for example, that the economy consists of only two people who are neither thieves nor philanthropists, and that they wish to exchange nuts and berries. Any exchange between them will necessarily follow what is known as Say's Principle (that is, any demand must be paid for

[2]See among others, Patinkin (1948, 1949, and 1951) and Becker and Baumol (1952).

[3]The expression "supply creates its own demand" does not appear to have been used before Keynes, but whether or not Keynes coined the term himself is not our concern here.

[4]"The Production, Distribution, and Consumption of Wealth" is, in fact, the subtitle of Say's *Treatise*.

[5]See "The Implications for Philanthropy, Theft, and Fiscal Policy," pp. 49-52 below.

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by the supply of something of equal market value).[6] If the two people were to sit down together and discuss the way in which the quantities of berries and nuts they demand and supply might vary with the relative price of nuts and berries, they could discover that the quantities are equal if the relative price is set at one berry equal to two nuts. As absolute prices may be expressed in terms of one of the goods (called the numéraire), we may express them in nuts and have the prices be: price of nuts = 1, price of berries = 2. If the exchange that takes place is, for example, that A gives *B* 3 berries in exchange for 6 nuts (which, of course, means that *B* gives A 6 nuts in exchange for 3 berries), then, by expressing demands as positive quantities and supplies as negative quantities, the exchange is shown as follows in Fig. 1.

1. A Market-Clearing Exchange of Nuts and Berries Between Two People

PERSON	NUTS p x q	BERRIES p x q	SUM	
A	1 x + 6	2 x - 3	0	Say's Principle
B	1 x - 6	2 x + 3	0	
SUM	0	0	0	Walras's Law (ex ante)

Market Clearing

To establish the commonly used terminology, we have used Say's Principle to mean that each row sums to zero; market clearing[7] to mean that each column sums to zero; and Walras's Law (*ex ante*)[8] to mean that the sum of the column totals (and, by necessity, the sum of the row totals) is zero.

It is, of course, unrealistic to assume that in a real economy the public would get together to determine market-clearing prices before trading.[9]

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[6]This principle does not come from the writings of Say, but is a tool invented by Clower (1965, chap. 5).

[7]Market clearing means that the quantity demanded is equal to the quantity supplied. We do not say that the market is in equilibrium (though it could be), as this would imply too much. Although not relevant in this simple exchange, equilibrium in a complete market economy implies a long-run condition where producers are earning normal profit and there is no incentive for firms either to enter or leave the various industries.

[8]Walras's Law is a term invented by Lange (1942, p. 50). I have, however, designated the law as being "*ex ante*" as it relates to people's intentions only. This concept has also been called "aggregate Say's Principle." See, for example, Edwards (1985, pp. 124-40; 1991).

[9]Such a procedure is referred to as operating with "a Walrasian auctioneer."

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Although *tâtonnement* ("groping by trial and error"–implying here a groping towards a market-clearing price[10]) might be expected, even then, people trade at the prices stated in the marketplace in accordance with their own subjective evaluation as to whether they would gain from the trade, regardless of whether these prices would clear the market.[11] Even though people (who are neither thieves nor philanthropists) would still plan their exchanges in accordance with Say's Principle (that is, each individual's supplies and demands will be equal in "nut value"), markets do not necessarily clear. Our participants could *intend* to trade in accordance with Fig. 2, but clearly these exchanges could not be accomplished because the total intended quantities supplied and demanded in each market are not equal.

2. Nonmarket-Clearing Intentions
of Two People To Exchange Nuts and Berries

PERSON	NUTS p x q	BERRIES p x q	SUM	
A	1 x + 6	2 x - 3	0	Say's Principle
B	1 x - 8	2 x + 4	0	
SUM	- 2	+ 2	0	← Walras's Law (ex ante)
	↑ Excess Supply	↑ Excess Demand		

In this chart, each row sums to zero, so Say's Principle still holds (by the assumption that only market trades are allowed); the columns do not sum to zero, so individual market clearing does not hold; but Walras's Law (*ex ante*) still holds because the row totals and the column totals still sum to zero.

INCREASING THE NUMBER OF MARKETS AND THE NUMBER OF PARTICIPANTS

Obviously, no matter how many people or markets are involved, so long as each person's intentions are in accordance with Say's Principle, Walras's Law

[10]Léon Walras's general equilibrium terminology–in the original French–is traditionally used in this discussion.

[11]Even though it is probably the case that a great deal of trading takes place at prices other than the market-clearing prices, the phenomenon is referred to as "false trading." See, for example, Hicks (1961, p. 128).

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(*ex ante*) always holds, and any excess demands are matched by equally valued excess supplies in other markets. Fig. 3 extends the concept to three (or more) people's nonmarket-clearing intentions to exchange nuts, berries, and fruit.

3. Nonmarket-Clearing Intentions of Three (or More) People To Exchange Nuts, Berries, and Fruit

Relative prices are: nuts = 1; berries = 2; fruit = 1/2

PERSON	NUTS p x q	BERRIES p x q	FRUIT p x q	···	SUM	
A	1 x + 6	2 x - 6	½ x + 12	···	0	← Say's Principle
B	1 x - 4	2 x + 4	½ x - 8	···	0	← Say's Principle
C	1 x + 5	2 x - 6	½ x + 14	···	0	← Say's Principle
:	:	:	:	:	:	
SUM	+ 7	- 16	+ 9	···	0	← Walras's Law (ex ante)
	↑ Excess Demand	↑ Excess Supply	↑ Excess Demand			

The framework of trade between any number of traders and any number of markets can be used to represent the actions of both consumers and producers. The table presents individuals (*A*, *B*, *C*, etc.) supplying and demanding goods (nuts, berries, fruit, etc.), but an individual may be thought of as a consumer supplying factor services and demanding final goods and services, and a producer may be thought of as demanding factor services and raw material inputs and supplying intermediate or final goods and services. However, no matter how many producers or consumers there are, it *must* be the case that if Say's Principle holds (that is, each row sums to zero), then the excess demands and excess supplies must sum to zero (that is, Walras's Law *ex ante* holds).

BORROWING AND LENDING

A common feature of a market economy that has not as yet been included in our analysis is the existence of borrowing and lending, but this too may easily be added. Let us assume, as an example, that nuts (the numéraire) may be borrowed and lent. Those who wish to borrow will supply nut-denominated IOUs (promising to repay a stated quantity of nuts at a definite future date), and those who wish to lend nuts will demand these IOUs, paying for them at current market prices. If we assume that the IOUs are promises to pay 1 nut five years from now, then the market price of ¾ of a nut will be equivalent to

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an annual interest rate of roughly 6 percent.[12] Selling the nut IOUs then makes no difference to the basic framework we have used; it simply adds a market.

4. Nonmarket Clearing Intentions of Three (or more) People To Trade Nuts, Berries, and Fruit and to Borrow and Lend Nuts

PERSON	NUTS p x q	NUT IOUS p x q	BERRIES p x q	FRUIT p x q	...	SUM	
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	...	0	← Say's Principle
B	1 x - 6	¾ x + 4	2 x - 8	½ x + 38	...	0	← Say's Principle
C	1 x + 2	¾ x + 4	2 x - 6	½ x + 14	...	0	← Say's Principle
:	:	:	:	:	:	:	
SUM	+ 1	0	- 14	+ 13	...	0	← Walras's Law (ex ante)
	↑ Excess Demand	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand			

The nut IOU market is here represented as clearing–not an unrealistic situation if we think of the IOU market being run by dealers who stand ready to buy and sell the IOUs from their own portfolios–but it doesn't have to clear. Obviously, there can be unsatisfied borrowers and unsatisfied lenders in the market, just as there can be unsatisfied suppliers and demanders of any other good.

EXTENSION TO THE MACROECONOMY

Many traditional macroeconomic models consist of just four markets–output, factors, bonds, and money–and these may be substituted for the four markets we have used. If we think of nuts as money, then nut IOUs become bonds, berries may then be thought of as factor services, and fruit as all other goods and services. The only difference is that these four markets represent the whole economy, so there cannot be more markets. In switching to a whole economy in the real-world sense, it would also make sense to designate the participants in some way other than as "persons," as many transactions are carried out by institutions or by collective groups like businesses or households. We will, therefore, now consider the various participants to be unspecified "agents":

[12]Actually, a little over 5.92 percent.

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5. Nonmarket-Clearing Intentions of All Agents To Trade, Borrow, and Lend

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0	← Say's Principle
B	1 x - 6	¾ x + 4	2 x - 8	½ x + 38	0	← Say's Principle
C	1 x + 2	¾ x + 4	2 x - 6	½ x + 14	0	← Say's Principle
:	:	:	:	:	:	
SUM	+ 1	0	- 14	+ 13	0	← Walras's Law (ex ante)
	↑ Excess Demand	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

This is the market framework originally envisaged by Oskar Lange (1942),[13] in which he supported Keynes's contentions concerning the neoclassical economists' interpretation of Say's Law. He did this by discussing the difference between what he called "Say's Identity" and what later came to be known as "Say's Equality."[14]

Say's Identity

What Lange called "Say's Identity" was a specification of what Keynes considered to be the obviously false Say's Law. What Keynes thought that the classical (read neoclassical) economists were doing was specifying Walras's Law *ex ante* for a barter economy, and then adding the money market later as an intended explanation of where the general price level came from. In the *General Theory*, Keynes (1936, chap. 2) had accused them quite specifically of making this error, offering as "proof" his now famous misquotation of John Stuart Mill.

A specification of Walras's Law *ex ante* for a barter economy states that any excess demand will be matched by an excess supply, and vice versa.

6. A Barter Economy (goods, services, and bonds, but no money)[15]

AGENT	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	¾ x - 8	2 x + 7	½ x - 16	0	← Say's Principle
B	¾ x + 4	2 x - 8	½ x + 26	0	← Say's Principle
C	¾ x + 4	2 x - 6	½ x + 18	0	← Say's Principle
:	:	:	:	:	
SUM	0	- 14	+ 14	0	← Walras's Law for a Barter Economy
	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

[13]Where we have set Lange's *n* markets equal to four.

[14]So named by Becker and Baumol (1952, p. 360).

[15]The existence of bonds in a barter economy would mean that the bonds were promises to pay goods or services in the future.

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However, if we specify that this situation exists *within a money economy*, then we have a serious problem in explaining how a money economy works. If Walras's Law *ex ante* applies to the money economy (which it does by the assumption of Say's Principle) as well as to the barter economy within it, then it is *necessarily the case* that individuals cannot change their money balances under any conditions–the excess demands and excess supplies of money must be identically equal to zero.

Agent	Bonds p x q	Factor Services p x q	Goods & Services p x q	Sum for Barter Economy	Money p x q	Sum for Money Economy
A	¾ x - 8	2 x + 7	½ x - 16	0	1 x 0	0
B	¾ x + 4	2 x - 8	½ x + 26	0	1 x 0	0
C	¾ x + 4	2 x - 6	½ x + 18	0	1 x 0	0
:	:	:	:	:	:	:
Sum	0	- 14	+ 14	0	0	0
	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand	↑ Say's Identity	↑ Requirements for Say's Identity to Exist	↑ Walras's Law for a Money Economy

For Say's Identity to exist within a money economy that conforms to Walras's Law *ex ante* requires the excess demands for money to be identically equal to zero. That this is untenable can easily be shown by considering a simple exchange of berries and fruit between two people at market-clearing prices. Let the price of berries be 2 units of money, and the price of fruit be half a unit of money. If *A* and *B* exchange 6 berries for 24 fruit, then neither *A* nor *B* would need to change money balances:

Person	Money p x q	Berries p x q	Fruit p x q	Sum
A	1 x 0	2 x - 6	½ x + 24	0
B	1 x 0	2 x + 6	½ x - 24	0
Sum	0	0	0	0
	↑	↑	↑	

Market Clearing

However, if we consider the berry and fruit markets without any reference to the money (that is, we look at the exchange as though it were a barter exchange), the money prices (2 and ½) are no longer linked to the money supply. The demands and supplies are related to the *relative prices* only:

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PERSON	BERRIES p x q	FRUIT p x q	SUM
A	2 x - 6	½ x + 24	0
B	2 x + 6	½ x - 24	0
SUM	0	0	0

Market Clearing Say's Identity

If we double the money prices to 4 and 1 respectively, the relative prices (and, hence, the demands and supplies) are unchanged:

PERSON	BERRIES p x q	FRUIT p x q	SUM
A	4 x - 6	1 x + 24	0
B	4 x + 6	1 x - 24	0
SUM	0	0	0

Market Clearing Say's Identity

In such a situation, the *price level* is arbitrary, and if the money prices are changed, there is no market mechanism to return them to where they were before. In a money economy, however, this is not the case. If we double the prices (as above), then money balances will be cut in half. To replenish these balances to their former *real* level would require an excess demand for money balances–and, by Walras's Law, an excess demand for money requires an excess supply of all other goods:

PERSON	MONEY p x q	BERRIES p x q	FRUIT p x q	SUM
A	1 x + 6	4 x - 7	1 x + 22	0
B	1 x + 5	4 x + 5	1 x - 25	0
SUM	+ 11	- 8	- 3	0

Excess Demand Excess Supply Walras's Law

The excess supplies in the markets for berries and fruit would then reduce the money prices back to where they were originally. As Patinkin (1965, pp. 193-95 and 272-73) pointed out, Say's Identity would mean that absolute money prices were indeterminate, and it would deny all versions of the quantity theory of money.

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Say's Equality

If we include money as well as the goods and services in the specification of Walras's Law, then what later came to be referred to as "Say's Equality" can be seen as a simple "if and only if statement" derived from that law: The excess supplies and demands of all markets other than money (the $n - 1$ markets) will exactly offset each other *if and only if* the money market (the *n*th market) clears.

7. Say's Equality: The Money Market (the *n*th) Clearing in the Framework of Walras's Law (*ex ante*)

AGENT	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM		MONEY p x q
A	¾ x - 8	2 x + 7	½ x - 26	- 5		1 x + 5
B	¾ x + 4	2 x - 8	½ x + 38	+ 6		1 x - 6
C	¾ x + 4	2 x - 6	½ x + 16	- 1		1 x + 1
:	:	:	:	:		:
SUM	0	- 14	+ 14	0	iff	0 ← Say's Equality

"n-1" Market Clearing — "nth" Market Clearing

Say's Equality has important corollaries. First, it clarifies the place that money has in the economy, showing how money-supply increases lead to general price increases. In the neo-Walrasian framework we have so far adopted, any increase in the general price level of goods and services could only be caused by an excess demand for those goods and services. Say's Equality shows how an excess supply of money will be matched by an equally valued excess demand in the remaining $n - 1$ markets.

8. Say's Equality with Excess Supply in the Money Market

AGENT	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM		MONEY p x q
A	¾ x - 8	2 x + 7	½ x - 26	- 5		1 x + 5
B	¾ x + 4	2 x - 8	½ x + 42	+ 8		1 x - 8
C	¾ x + 4	2 x - 6	½ x + 16	- 1		1 x + 1
:	:	:	:	:		:
SUM	0	- 14	+ 16	+ 2	iff	- 2 ← Say's Equality

Excess Demand in the "n-1" markets (other than money) — Excess Supply of Money

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This example has an excess supply of money that arises from the fact that *B* chooses to take more money out of money balances than *A* and *C* choose to add to theirs, but it is important to our understanding of monetary policy that we see money supply increases emanating from the banking system. First, a central bank that can carry out open market operations creates money that can then be used to purchase bonds in the open market. These additions to monetary base are then used by the depository institutions to make loans and create further money (that is, purchase money IOUs) as the so-called multiple expansion of deposits. As far as our framework is concerned, money is created and put into circulation by the banking system's purchase of bonds. Any increase in the money supply (whether the result of the central bank's open market operations, or the banking system's multiple expansion of deposits) will be matched by an equal increase in the demand for bonds. The newly created money is then added to the money supply (as an excess supply of money), which causes there to be an excess demand for goods and services (in addition to any excess demand that might already exist), and hence puts an upward pressure on the general price level.

9. The Addition of Money Creation by the Banking System

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0	← Say's Principle
B	1 x - 6	¾ x 0	2 x - 8	½ x + 44	0	← Say's Principle
C	1 x + 2	¾ x 0	2 x - 6	½ x + 20	0	← Say's Principle
:	:	:	:	:	:	
Banking System	1 x - 6	¾ x + 8			0	← Walras's Law (ex ante)
SUM	- 5	0	- 14	+ 19	0	
	↑ Excess Supply	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

Apart from Lange's deductions about money, it is probably at least as important to point out that Say's Equality also gives the lie to an important Keynesian assertion: that unemployment of factor services is caused by deficient demand for goods and services.[16] If the money market and the bond markets are priced to clear (as in case 6 above), then unemployment of factor services must always be accompanied by an excess demand for goods and

[16]Keynes wrote exclusively of the unemployment of labor, but in our framework it applies equally to the unemployment of any factor service.

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services. Conversely, deficient demand for goods and services (that is, excess supply) will, in the absence of excess demands or excess supplies in the money or bond markets, cause there to be an excess *demand* for factor services. Lange (1942, p. 61) recognized that this point had been covered quite explicitly in the discussions between Ricardo and Malthus, and pointed out that Malthus's notion of an excess supply of goods and services being accompanied by an excess supply of factor services merely requires a sufficient excess demand for money in order to be valid.

Faced with the very same problem with Keynes's *General Theory*, Lange, rather strangely, does not use the same rationalization. The same argument could easily have been used: The Keynesian "liquidity trap" is usually explained as an *infinite* demand for money, which would clearly be adequate to cover all conceivable combinations of excess demands and supplies in the other $(n - 1)$ markets–including, of course, the case of an excess supply in both the market for goods and services and the market for factor services. Lange, however, creates a special case for Keynesian theory:

> The excess supply of . . . (factor services) . . . is, however, not the same as "involuntary unemployment" in the Keynesian sense. "Involuntary unemployment," as defined in the Keynesian theory, is not an excess of supply of labor but *an equilibrium position* obtained by the intersection of a demand and of a supply curve, the supply curve, however, being infinitely elastic with respect to money wages over a wide range. (Lange 1942, p. 61n., italics in original)

This "explanation" is, however, no explanation at all. If the labor market is said to be "in equilibrium" when there is "involuntary unemployment," then presumably the other markets could be in equilibrium, too, and the idea of unemployment being caused by deficient demand for goods and services disappears. Even if we used the explanation Lange used for Malthus and included Keynes's strange liquidity-trap notion, the unemployment of factor services is no longer *caused* by the deficient demand for goods and services: the unemployment *and* the deficient demand for goods and services are both caused by the excess demand for money.

Monetary Theory and Policy after Lange

Before Lange, the meaning of Say's Law for monetary theory and policy could hardly be debated because of the obvious confusion regarding the exact meaning of the law. Many were prepared to accept that what we have called Walras's Law *ex ante* was that law. Others believed that Say's Principle was Say's Law. Following Keynes, Lange himself (and Patinkin after him), claimed that Say's Identity was what the neoclassical economists meant by Say's Law. Lange's analysis, therefore, clearly brought order to the debate, and contributed greatly to the discussion of (neo)classical monetary theory and policy,

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even though it may well have diverted attention from the message that Say himself had intended to convey. Becker and Baumol (1952), attempted to demonstrate that the classical and neoclassical economists from the very early days had believed that monetary theory was based on Say's Equality, but whether or not they were correct, it is certainly the case that those neoclassical economists who came *after* Lange adopted Say's Equality as their own.

In matters of theory, the modern neoclassical economists centered their investigations on Walras's Law and the conditions under which the economy "tends" toward full employment. In matters of monetary policy, their discussions centered on the light that Say's Equality could shed on the consequences of money-supply changes. Neoclassical replies to Keynes and the Keynesians consisted, not of denying Keynes's characterization of their position, but simply in denying that they had reached their conclusions based on what Lange had called "Say's Identity."

The view that under conditions of flexible wages and prices and no frictional unemployment, the economy would tend to move toward full employment can easily be explained using Walras's Law *ex ante*. Take, for example, our statement of Walras's Law *ex ante* in Fig. 5 from above.

5. Nonmarket Clearing Intentions of All Agents to Trade, Borrow, and Lend

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0	← Say's Principle
B	1 x - 6	¾ x + 4	2 x - 8	½ x + 38	0	← Say's Principle
C	1 x + 2	¾ x + 4	2 x - 6	½ x + 14	0	← Say's Principle
:	:	:	:	:	:	
SUM	+ 1	0	- 14	+ 13	0	← Walras's Law (ex ante)
	↑ Excess Demand	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

Here there is an excess supply of factor services (that is, there is unemployment), but this is matched by an excess demand for both goods and services and for money. If wages and prices are flexible, then the excess supply of factor services would cause wages (and the prices of other factor services) to fall, and the excess demand for goods and services would cause the general price level to rise. These price changes would eliminate the excess supplies and excess demands, and the economy would move to full employment.

Say's Equality may be used to explain the modern neoclassical economists' views on monetary policy, and their conclusions are not unlike those reached by Say himself. Say, who believed that money was neutral, simply considered that money-induced changes in the nominal interest rate would not

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affect the real rate, and would therefore have no real effects on the economy. This is basically the neoclassical response to the Keynesian view. The Keynesians believe that if the economy has unemployed factor services, an increase in the money supply removes the unemployment simply by lowering the interest rate and inducing real investment in capital equipment. Based on the belief that this would increase aggregate demand, and that the increased demand would necessarily call forth an increased supply of goods and services, the Keynesians believed that the economy would be lifted out of the recession.

Modern neoclassical economists, on the other hand, use Say's Equality to show that the Keynesian story is invalid. Although open market operations can cause a temporary rise in the price of bonds (and a temporary fall in the interest rate), this will not necessarily change the level of unemployment at all, as it may not change the prices in the labor market. Assume that we start with Fig. 9 above, which shows a situation of unemployment in an economy where the money supply can be changed by the monetary system:

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0	← Say's Principle
B	1 x - 6	¾ x 0	2 x - 8	½ x + 44	0	←
C	1 x + 2	¾ x 0	2 x - 6	½ x + 20	0	←
:	:	:	:	:	:	
Banking System	1 x - 6	¾ x + 8			0	
SUM	- 5	0	- 14	+ 19	0	← Walras's Law (ex ante)
	↑ Excess Supply	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

If the Federal Reserve increases the money supply by an open market operation (that is, buys more bonds), this will increase the price of bonds and lower the interest rate. For instance, if the price of bonds rises from ¾ to ⅘. For a five-year bond with a face value of 1, this will lower the rate of interest to approximately 4.57 percent. The increase in demand for bonds will cause the quantity of bonds supplied to increase, but Say's Principle makes clear that there is nothing to say that unemployment will be reduced. The purchase of bonds by the monetary authority and the banks will increase money balances, and this increase in the excess supply of money will cause an increase in the excess demand for goods and services—which will increase the pressure for the prices of goods and services to rise:

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AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x + 5	4/5 x - 10	2 x + 7	½ x - 22	0	← Say's Principle
B	1 x - 6	4/5 x 0	2 x - 8	½ x + 44	0	← Say's Principle
C	1 x + 2	4/5 x 0	2 x - 6	½ x + 20	0	← Say's Principle
:	:	:	:	:	:	
Banking System	1 x - 8	4/5 x + 10			0	
SUM	- 7	0	- 14	+ 21	0	← Walras's Law (ex ante)
	↑ Excess Supply	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

Whether or not there is *any* resulting change in employment depends on whether the changes in the prices of goods and services cause a change in real wages. This, of course, will depend on whether money wages change relative to the prices of goods and services, and has been the source of much debate about the effects of expectations in the economy.

Hayek, however, had shown the inadequacy of both the Keynesian view and the neoclassical response long before Keynes even wrote the *General Theory*,[17] but this too may be shown using the framework presented here. To explain the effects of a monetary increase (and a concomitant decrease in the nominal interest rate), it is necessary to disaggregate and separate the markets for capital goods from the markets for consumer goods and services. Let us assume that we start from the following, where agent *A* represents consumers, agent *B* represents the producers of consumer goods (who are the purchasers of capital goods), and agent *C* represents the producers of capital goods:

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	CONSUMER GOODS p x q	CAPITAL GOODS p x q	SUM	
A	1 x - 2	¾ x + 8	2 x - 13	½ x + 44	4 x 0	0	← Say's Principle
B	1 x 0	¾ x - 4	2 x + 10	½ x - 42	4 x + 1	0	← Say's Principle
C	1 x + 3	¾ x - 4	2 x + 2	½ x 0	4 x - 1	0	← Say's Principle
:	:	:	:	:	:	:	
SUM	+1	0	- 2	+ 1	0	0	← Walras's Law (ex ante)
	↑ Excess Demand	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand	↑ Market Clearing		

[17]See Hayek (1978a) *Monetary Theory and the Trade Cycle*, originally submitted to the University of Vienna in 1929 as *Geldtheorie und Konjunkturtheorie* for his habilitation, also Hayek (1978b), *Prices and Production*, first published in London in 1931.

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If we now assume that this state of affairs is disturbed by the banking system injecting money into the economy (by a combination of open market operations by the central bank and the multiple expansion of deposits by the commercial banks), we can expect the other agents in the economy to react and the prices in the various markets to be affected. Barring any notion of an infinite demand for money balances by all agents, the higher money balances will cause changes in the agents' supplies and demands in the other markets. As we have seen, neoclassical theory would tell us that the supplies and demands would change in such a way as to cause inflation, but as Hayek explained, it is much more complicated than this.

This purchasing of bonds by the banking system will cause the price in the bond market to be bid up, and the nominal interest rate to be bid down, but this activity by the banking system obviously causes a change in the excess supplies and excess demands in markets other than those for bonds and money. The excess demands and the excess supplies are still equal in the aggregate (that is, Walras's Law *ex ante* still holds), and there is in our example an excess supply of money where there used to be an excess demand, but there are serious changes in the markets for factor services, consumer goods, and capital goods. The lower interest rates do, indeed, cause an increase in the demand for capital goods, but Say's Principle shows that the production of these capital goods bids resources away from the production of consumer goods. This may well bid up the prices of factor services and cause increases in the prices of the capital goods, but at the same time, it will cause the supplies of consumer goods to be reduced as the demand for them increases, thus increasing the excess demand for consumer goods and adding pressure for a rise in the prices of consumer goods.

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	CONSUMER GOODS p x q	CAPITAL GOODS p x q	SUM	
A	1 x 0	5/6 x + 6	2½ x - 16	5/8 x + 56	5 x 0	0	← Say's Principle
B	1 x 0	5/6 x - 6	2½ x + 8	5/8 x - 40	5 x + 2	0	
C	1 x 0	5/6 x - 6	2½ x + 6	5/8 x 0	5 x - 2	0	
:	:	:	:	:	:	:	
BANKS	1 x - 5	5/6 x + 6					
SUM	- 5	0	- 5	+ 10	0	0	← Walras's Law (ex ante)
	↑ Excess Supply	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand	↑ Market Clearing		

Clearly, if the price of factor services is bid up (as in our example), it is quite possible that unemployment is *increased* rather than decreased. At higher

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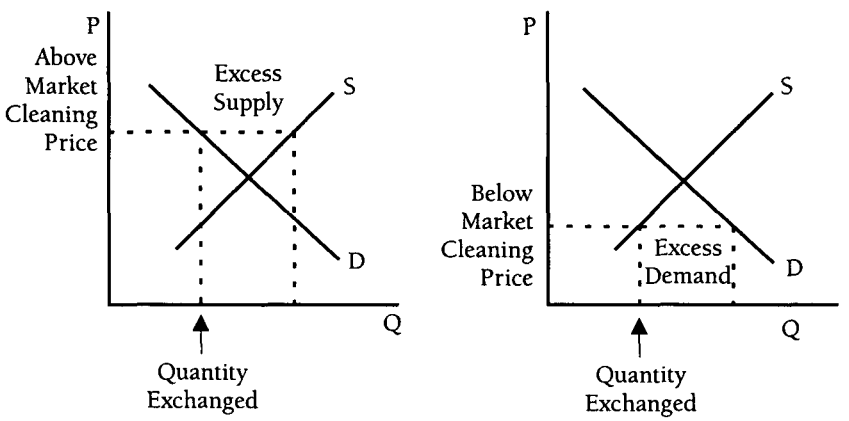
wages, it would not be unreasonable to assume that agent *A* would increase the quantity of factor services supplied, while agents *B* and *C* would reduce the quantity demanded. Hayek's explanation, of course, goes on to explain how the misallocation of resources that results from the increase in investment in the face of reduced saving leads to the business cycle, but Say's Principle clearly plays a crucial role in the explanation of how this will occur.

Clower's Dual-Decision Hypothesis

An important change in the whole discussion came about with the publication of Clower's (1965, p. 287) dual-decision hypothesis. Clower pointed out that all the reasoning we have used so far relies on the use of people's *intentions* (that is, we are using Walras's Law *ex ante*), but intentions are not always realized in the marketplace, and this would cause the line of reasoning to break down. This can easily be seen from simple supply-and-demand diagrams. Obviously, if there are excess demands and excess supplies, some people simply cannot do what they intend to do. When prices are not market-clearing, what actually takes place is an exchange of the quantity supplied *or* the quantity demanded, *whichever is the lesser.* Excess supplies are quantities not sold, and excess demands are quantities not bought:



This means that we have a problem with interpreting both Say's Principle and Walras's Law. Say's Principle, as we have stated it, is an *ex ante* concept, meaning that only if supplies are sold will they finance the quantities demanded. *Ex post* the quantities demanded must be financed from the actual sales of supplies.

Using our simple exchange framework, let us take the simplest case of nonmarket-clearing as shown in Fig. 2 above.

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PERSON	NUTS p x q	BERRIES p x q	SUM
A	1 x + 6	2 x - 3	0
B	1 x - 8	2 x + 4	0
SUM	- 2	+ 2	0

Say's Principle

Walras's Law (ex ante)

Excess Supply

Excess Demand

Clearly, person *B* cannot sell 8 nuts in this market because *A* (the only other participant) is demanding just 6, and if *B* sells 6 nuts this will finance a demand of only 3 berries. *B*'s *intended* demand of 4 berries would cost 8 nuts, and *B* will only have 6. Clower's point was that once *B* finds out that only 6 nuts are sold, a new decision must be made about the demand for berries because the purchases are constrained by the sales. In this case, the demand for berries cannot exceed what can be paid for with 6 nuts (that is, only 3 berries can be bought). Clower's conclusion was therefore, that although Walras's Law may be true *ex ante*, it certainly could not be true *ex post* in any situation where there are excess demands and excess supplies. Thus, whatever Say's Law might be, if it is derived from Walras's Law holding *ex post*, it could not be valid.

Clower (1965, p. 290) offered his dual-decision hypothesis as an explanation of why there may not be a tendency for the economy to return to full employment, and quite explicitly as a theoretical basis for Keynes's *General Theory*. Unemployment caused by money wages that are too high (that is, above market clearing), will be removed automatically if the prices of goods and services rise. However, the prices of goods and services will only rise if there is excess demand for them. If, as in Clower's hypothesis, excess supplies for factor services are not matched by excess demands for goods and services, there is no force to move the economy in the direction of full employment. According to Leijonhufvud (1974, p. 167n.), Clower rejected his hypothesis almost as soon as he had written it, but it is still important as the starting point of the modern neoclassical defense of Say's Law as an equilibrating force. Our current understanding of what we might call the *dynamic* version of Say's Law (that is, the process whereby the economy returns to a full-employment equilibrium in an economy with flexible wages and prices) comes from the criticism of Clower's hypothesis.

Edwards's Reply to Clower

Edwards (1985) has pointed out that Clower's dual-decision hypothesis is based on a misunderstanding of how a money economy functions. The hypothesis is explained using the simplest possible disequilibrium situation in a barter economy, but our economy is a *money* economy, and the way in

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which money is used is crucial to the outcome. Only in a barter economy do current demands for goods and services depend on current supplies of goods and services. In a money economy people keep money balances as a buffer stock that separates the act of supplying from the act of demanding. People's demands are made based on the amount of money balances they are holding, and the income from supplying factor services (for example, wages) are used to replenish the money balances. The proportion of money balances that people will intend to spend will depend on their expectation of being able to sell goods or services. If people earn more from their sales (of goods, services, or factors), than they spend on their purchases (of goods, services, or factors), then their money balances will increase. If people earn less from their sales (of goods, services, or factors) than they spend on their purchases (of goods, services, or factors) then their money balances will decrease. For the most part, we can expect that people hold money balances (of perhaps some specific real value) and then carry out their sales and purchases so as to maintain these money balances intact. This will mean that, in general, they intend neither to add to nor take from their money balances.

As an example, let us take the intended transactions of individual agents who are offering to buy and sell factor services, to borrow and lend money, and to buy and sell final goods and services, but who do not intend to change their money balances:

10. Maintaining Constant Money Balances

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM	
A	1 x 0	¾ x - 8	2 x + 8	½ x - 20	0	← Say's Principle
B	1 x 0	¾ x + 4	2 x - 7	½ x + 22	0	← Say's Principle
C	1 x 0	¾ x + 4	2 x - 6	½ x + 18	0	← Say's Principle
:	:	:	:	:	:	
SUM	0	0	- 10	+ 10	0	← Walras's Law (ex ante)
	↑ Constant Money Balances	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand		

Because we are talking about intentions, we have a statement of Walras's Law *ex ante*–the bond market is assumed to clear, so the excess supply in the factor markets is matched by an excess demand in the markets for goods and services. However, Clower maintained that these intentions cannot all be realized. *B*'s and *C*'s demands for goods, services, and bonds depend on their ability to sell their intended amounts of factor services, and they cannot do

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this because *A* is prepared to buy less factor services than they are offering. Edwards's point is that if sales in the factor market are limited by the demand (that is, *B* and *C* can only sell a total of 16 money's worth of factor services), then *B* and *C*'s demands for goods and services will be partly financed by reductions in money balances. If we assume that *B* and *C* each sell 8 money's worth of factor services, then with the other market intentions staying the same, *B* must reduce money balances by 6, and *C* must reduce money balances by 4. The excess demand for goods and services (a money's worth of 10) is a real demand because *A* and *B* intend to finance that demand by reducing money balances instead of using the intended excess supply in the factor market. Although *B* and *C intend* to reduce their money balances to finance their demands for goods and services, the actual money balances are unchanged for the simple reason that this is an *excess demand* for goods and services that will not be realized. Edwards's explanation shows, therefore, that what we have characterized as Walras's Law *ex ante* applies *ex post* as well. This can be seen if we look, not simply at people's intentions, but at their actual exchanges and their unfulfilled desires to make exchanges separately.

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM OF ALL ACTUAL AND INTENDED TRANSACTIONS
A's Exchanges	**1 x 0**	**¾ x - 8**	**2 x + 8**	**½ x - 20**	**0**
unfulfilled desires	1 x 0	¾ x 0	2 x 0	½ x 0	0
B's Exchanges	**1 x 0**	**¾ x + 4**	**2 x - 4**	**½ x + 10**	**0**
unfulfilled desires	1 x 0	¾ x 0	2 x - 3	½ x + 12	0
C's Exchanges	**1 x 0**	**¾ x + 4**	**2 x - 4**	**½ x - 10**	**0**
unfulfilled desires	1 x 0	¾ x 0	2 x - 2	½ x + 8	0
:	:	:	:	:	:
Sum of all actual and intended transactions	0	0	- 10	+ 10	0
	↑ Constant Money Balances	↑ Market Clearing	↑ Excess Supply	↑ Excess Demand	↑ Walras's Law (ex ante and ex post)

In this example, *A* is able to make all intended exchanges because wherever there is an excess supply, *A* is the demander, and wherever there is an excess demand, *A* is the supplier. *B* and *C*, on the other hand, cannot carry out all of their intentions. Let us assume, as an example, that of the 8 factor

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services demanded (by *A*), *B* and *C* each supply 4, and of the 20 goods and services supplied (by *A*), *B* and *C* each purchase 10. This means: *B* has an unfulfilled desire to sell 3 units of factor services and has an unfulfilled desire to purchase 12 units of goods and services; and *C* has an unfulfilled desire to sell 2 units of factor services and an unfulfilled desire to purchase 8 units of goods and services.

The issue, for this interpretation of Say's Law, is: given that not all supplies and demands can be carried out, do the excess demands and the excess supplies (that would cause prices to move so that the economy moves toward full employment) still exist? Clower had stated that because *B*'s excess demand for goods and services could only be financed by *B*'s excess supply of factor services, and because *C*'s excess demand for goods and services could only be financed by *C*'s excess supply of factor services, the excess demand for goods and services would not exist; they would be "notional" demands. Edwards, on the other hand, points out that the excess demand is real. *B*'s desire to buy goods and services depends on *B*'s money balances, not on the sale of factor services. If *B* doesn't sell enough factor services to finance all of the purchases, then the remainder will come from money balances. In our example, *B* has an excess demand for goods and services (of 6 units of money's worth). *B* intends to buy these goods and services using 6 units of money that are currently being held in money balances. We do not, however, see a reduction in *B*'s money balances because *B* cannot actually buy the goods and services (it is an excess demand that is an *unfulfilled desire* to spend money balances). Similarly, *C* intends to buy 4 units of money's worth of goods and services in excess of what is actually purchased. *C*'s money balances are not in fact reduced, because the money is intended for use in buying what is in fact an excess demand that is not being fulfilled. Thus, the excess supplies of factor services still exist, because *B* and *C* would like to sell more units than *A* is demanding; and the excess demands for goods and services still exist, because *B* and *C* have money balances that would cover the purchases if they could in fact be made. The excess demands and excess supplies exist *ex post*, so the forces that would cause the economy to move toward full employment are still intact. To summarize, most neoclassical economists seem to take the position that, in the absence of wage and price rigidity and in the absence of frictional unemployment, Say's Law explains the tendency of the economy to move to full-employment equilibrium.

The Views of William H. Hutt

In the years of debate that centered on Lange's neo-Walrasian explanation, very few seem to have noticed that Say's Law *as enunciated by Say* was not being addressed. Say predates the Walrasian concern with general equilibrium, so it should not be surprising that he did not address that issue in his

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writings. William Hutt seems to be virtually alone among the modern defenders of the law to state explicitly that Say's Law is not the oft quoted tendency for the economy to move to full-employment equilibrium under conditions of wage and price flexibility. In his explanation of the law, he criticizes all those who think that "Say's law is valid only as a long-term theorem; that it would hold under 'perfect price flexibility'; but that it is irrelevant to the price rigid world of reality" (Hutt 1974, p. 40). Hutt has shown quite clearly that what Say and the other early classical economists said could be explained without reference to any tendency of the economy to change over time. Say's Law, *per* Say himself, refers to the situation that exists *at a point in time*. Hutt saw Say's Law as an explanation of why depressions existed, not as an explanation of how they would automatically be removed if there was wage and price flexibility. Much can be said about what might happen in an economy on the way from unemployment to full employment, but *that* was not what was at issue in the law itself. Hutt states:

> Say's Law does *not*, then, "assume full employment" or imply that full employment is achievable whatever pricing (valuing) policies are adopted. It does *not* imply that market pressures will always be allowed to bring about pricing for market-clearance. What it *does* imply is that market pressures *could*, if permitted, have this effect. (1978, p. 39, italics in original)

The difference between Hutt's view and that of the neoclassical economists can be seen very clearly from an example he used that is quite similar to our discussion of supplying fruit and nuts in the market place. Hutt discusses the sale of fruit from his garden:

> When I sell fruit grown in my garden, what I receive and what the purchaser pays me are the same! *But what is equally true, and what illustrates Say's Law, is that I dispose of an identical value out of money's worth I receive from that sale* whatever I am destined to acquire in return for it; and what I acquire will be of identical value. This remains true (a) whether I invest in additional money, by simply retaining an additional money balance equal to the value of the fruit I sell, or (b) whether my consumption of goods and services increases by the value of my proceeds from the sale (or by something less than that), or (c) whether I invest the value of my sale in the replacement of goods and services being currently consumed, or (d) whether I do more than maintain the value of my assets intact and invest in additional non-money assets. (1978, p. 34, italics in original)

Hutt is here illustrating Say's Law (as it was originally stated by Say) using what we have called Say's Principle, except with one important difference: Hutt is talking about his *sales* and what he *does* with the proceeds, not about his intended *supplies* and what he *intends* to do with the proceeds if he is successful in the market place. As Hutt (p. 27) states, "Say's law directs attention to actual *transactions*"—a view that is easily substantiated in the writings of

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Say.[18] To Hutt, therefore, Say's Principle as an *ex ante* concept is not useful in explaining Say's Law. It only has value as an *ex post* concept.

To illustrate Hutt's perspective, let us use an example with excess demands and excess supplies in all markets (Fig. 11):

11. A General Case of Excess Demands and Excess Supplies in All Markets

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM
A	1 x + 8	¾ x - 12	2 x + 7	½ x - 26	0
B	1 x - 6	¾ x + 4	2 x - 8	½ x + 38	0
C	1 x + 2	¾ x + 4	2 x - 6	½ x + 14	0
:	:	:	:	:	:
SUM	+ 4	- 3	- 14	+ 13	0
	Excess Demand	Excess Supply	Excess Supply	Excess Demand	

← Say's Principle

← Walras's Law (ex ante)

We can then separate the actual exchanges from the unfulfilled desires to exchange:

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM OF ALL ACTUAL AND INTENDED TRANSACTIONS
A's Exchanges	**1 x + 5**	**¾ x - 8**	**2 x + 7**	**½ x - 26**	**0**
unfulfilled desires	1 x + 3	¾ x - 4	2 x 0	½ x 0	0
B's Exchanges	**1 x - 6**	**¾ x + 4**	**2 x - 4**	**½ x + 22**	**0**
unfulfilled desires	1 x 0	¾ x 0	2 x - 4	½ x + 16	0
C's Exchanges	**1 x + 1**	**¾ x + 4**	**2 x - 3**	**½ x + 4**	**0**
unfulfilled desires	1 x + 1	¾ x 0	2 x - 3	½ x + 10	0
:	:	:	:	:	:
Sum of all actual and intended transactions	+ 4	- 3	- 14	+ 13	0
	Excess Demand	Excess Supply	Excess Supply	Excess Demand	Walras's Law (ex ante and ex post)

[18]Say often uses the word "vente," and this is often (rather confusingly) written in English translations as "vent," but, as any dictionary will state, it means "sale." See, for example, Princep's translation of Say (1853, bk. 1, chap. 15).

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If we now look at the actual *exchanges* rather than people's intentions, we have Say's Law as explained by Hutt:

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0
B	1 x - 6	¾ x + 4	2 x - 4	½ x + 22	0
C	1 x + 1	¾ x + 4	2 x - 3	½ x + 4	0
:	:	:	:	:	:
SUM	0	0	0	0	0

Although this figure illustrates Say's Law, we should not think (following the procedure Lange followed in discussing the *ex ante* flows) that it is the sum of the rows (and, hence, the sum of the columns) being zero that constitutes the law. Hutt (1974, pp. 33-34) referred to this as simply "a sophisticated statement of the obvious." Say's Law of Markets, on the other hand, is that each sale, at the moment of sale, becomes a source of demand for some competing thing elsewhere in the economy. The money's worth of the sales dictates the money's worth of the demands. Because *A* sells 6 money's worth of bonds and 13 money's worth of goods and services, he can demand 14 money's worth of factor services and add 5 money's worth to money balances. Because *B* sells 8 money's worth of factor services and takes 6 money's worth from money balances, he can demand 3 money's worth of bonds and 11 money's worth of goods and services. Because *C* sells 6 money's worth of factor services, he can demand 3 money's worth of bonds and 2 money's worth of goods and services and add 1 money's worth to money balances. What everyone sells constitutes demand for noncompeting goods. In the aggregate, therefore, the money's worth of sales must always be matched by that same money's worth of demand, and there do not appear to be any exceptions to this rule. The statement is true whether or not the economy is at full employment.

If there is unemployment in the market for labor (that is, there is an excess supply of labor), the static view of Say's Law explains that this is so because of wage rigidities, but these rigidities are not caused by deficient aggregate demand for goods and services (as the Keynesians hold), but are the result of the suppliers of labor not pricing their services to sell. As Hutt puts it:

> The phrase "excess supply of labor" [is] . . . merely an indirect way of saying that some workers are "unemployable" *at the wage-rates for which they are holding out*. . . . [*W*]*hat is usually called "unemployed labor" could be more realistically called "unsupplied labor"*; and any labor which remains "unsupplied" represents, because it is over-priced, *a withheld potential contribution to the source of demands for non-competing outputs*. (1974, p. 79, italics in original)

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Implications for Philanthropy, Theft, and Fiscal Policy

Modern discussions of Walras's Law, Say's Equality, and Say's Principle have always been carried out with the caveat that all participants are "neither thieves nor philanthropists." Indeed, everything we have written so far has been based on this assumption. However, if we are to explain Say's Law as Say stated it, this caveat must be removed–Say explicitly included theft in his discussion. So far, we have only included *market* activities (supplies and demands, sales and purchases), but although "philanthropists making donations" and "thieves stealing" do not fit this description, it is not difficult to describe them using our previous scenario. Let us choose one of the participants from our previous examples (for example, agent *A* from Fig. 6 above):

Agent	Money p x q	Bonds p x q	Factor Services p x q	Goods & Services p x q	Sum
A	1 x + 5	¾ x - 8	2 x + 7	½ x - 26	0

If we now assume that *A* is a philanthropist who wishes to donate money that would otherwise be added to his money balances (in this case, 5 units of money) to someone who spends that money on goods and services, we can see that Say's Principle does not apply to *A*'s actions alone, but to *A* and the recipient together:

Agent	Money p x q	Bonds p x q	Factor Services p x q	Goods & Services p x q	Sum
A	1 x 0	¾ x - 8	2 x + 7	½ x - 26	- 5
Recipient	1 x 0	¾ x 0	2 x 0	½ x + 10	+ 5
				Aggregate Say's Principle →	0

If a philanthropist and the recipient of the philanthropist's donation are both included in the aggregate economy, it makes no difference to the truth of Walras's Law. It can, of course, change the excess demands and excess supplies in the various markets, but the sum of all the markets will still be the same: (Fig. 6 with Agent *A* being a philanthropist):

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AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM
A	1 x 0	¾ x -8	2 x + 7	½ x - 26	-5
RECIPIENT	1 x 0	¾ x 0	2 x 0	½ x + 10	+5
B	1 x -6	¾ x + 4	2 x -8	½ x + 38	0
C	1 x + 2	¾ x + 4	2 x -6	½ x + 14	0
:	:	:	:	:	:
SUM	-4	0	-14	+18	0

← Walras's Law

↑ Excess Supply ↑ Market Clearing ↑ Excess Supply ↑ Excess Demand

Different though it may be in practice, there is no difference to the aggregate amounts if *A* is robbed of 5 units of money instead of donating 5 units of money. If a thief steals the money and spends it in the market for goods and services, the outcome is exactly the same (Fig. 6 with agent *A* being robbed and the money being spent by the thief):

AGENT	MONEY p x q	BONDS p x q	FACTOR SERVICES p x q	GOODS & SERVICES p x q	SUM
A	1 x 0	¾ x -8	2 x + 7	½ x - 26	-5
THIEF	1 x 0	¾ x 0	2 x 0	½ x + 10	+5
B	1 x -6	¾ x + 4	2 x -8	½ x + 38	0
C	1 x + 2	¾ x + 4	2 x -6	½ x + 14	0
:	:	:	:	:	:
SUM	-4	0	-14	+ 18	0

← Walras's Law

↑ Excess Supply ↑ Market Clearing ↑ Excess Supply ↑ Excess Demand

Obviously, the presence of thieves and philanthropists makes no difference to the overall outcome. The demands of the thieves and of the recipients of the philanthropists' gifts will change the excess demands and the excess supplies, but it will not affect the validity of Walras's Law, Say's Equality, or Say's Law (by either the neoclassical "tendency to full employment" explanation, or of Say and Hutt's static version). However, for Say, the most significant point is that a combination of thievery and philanthropy is an apt description of government fiscal policy. Say actually used his law as a way of attacking the involvement of government (and monarch) in the economy of France.

Fiscal policy means simply that the government steals the public's assets (taxes them), and then either spends the money itself (what is usually termed "government expenditure") or donates the funds to others (makes subsidies),

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who then spend them. Clearly, the government may not make expenditures or donations unless someone has already supplied something of value to the market. The demands of the government or the recipients of government funds must always be matched by equally valued supplies. Even with government fiscal policy, it is still the supplies that "create" the demands, and fiscal policy may be seen as mere income redistribution that can have no effect on aggregate output or employment other than those caused by the misallocation of resources they impose on the economy.

Say was quite explicit on this point. In chapter six of his *Principles,* he states:

> There has long been a prevalent notion, that the values paid by the community for the public service, return to it again in some shape or other; in the vulgar phrase, that what government and its agents receive, is refunded again by their expenditure. This is a gross fallacy; but one that has been productive of infinite mischief. . . . The value paid to the government by the tax-payer is given without equivalent or return; it is expended by the government in the purchase of personal service, of objects of consumption; in one word, of products of equivalent value, which are actually transferred. (1853, p. 413)

Perhaps even more graphic, however, was Say's attack on the statements made by Voltaire concerning the expenditures of Louis XIV:

> When Voltaire tells us, speaking of the superb edifices of Louis XIV, that they were by no means burdensome to the nation, but served to circulate money in the community, he gives us decisive proof of the utter ignorance of the most celebrated French writers of his day upon these matters. He looked no further than the money employed on the occasion; and when the view is limited to that alone, the extreme prodigality exhibits no appearance of loss. . . . The vigilance of the historian should have traced the 167 millions of dollars expended on the chateau of Versailles alone, from the original production by the laborious efforts of the productive classes of the nation, to the first exchange into money, wherewith to pay the taxes, through the second exchange into building materials, painting, gilding, etc. to the ultimate consumption in that shape, for the personal gratification of the vanity of the monarch. The money acted as a mere means of facilitating the transfers of value in the course of the transaction; and the winding up of the account will show, a destruction of value to the amount of 167 million of dollars, balanced by the production of a palace, in need of constant repair, and of the splendid promenade of the gardens. (1853, p. 415)

In a footnote to his discussion, Say quotes a certain Dr. Hamilton who wrote a tract on *The National Debt of Great Britain*, who compared government fiscal policy to

> the forcible entry of a robber into a merchant's house, who would take away his money, and tell him he did him no injury, for the money, or part

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> of it, would be employed in purchasing the commodities he dealt in, upon which he would receive a profit. (p. 413n.)

Say's Law as a condemnation of government fiscal policy survived at least through the classical period. John Stuart Mill, who learned it either from Say himself (he lived with the Say family for a time in his youth) or from his father (some actually attribute the law to James Mill rather than to his friend Say), expressed the law in the same way *and* condemned fiscal policy in the same way, even including an embellished rendition of Hamilton's story:

> The utility of a large government expenditure, for the purpose of encouraging industry is no longer maintained. Taxes are not now esteemed to be "like the dews of heaven, which return again in prolific showers." It is no longer supposed that you benefit the producer by taking his money, provided you give it to him again in exchange for his goods. There is nothing which impresses a person of reflection with a stronger sense of the shallowness of the political reasonings of the last two centuries,[19] than the general reception so long given to a doctrine which, if it proves anything, proves that the more you take from the pockets of the people to spend on your own pleasures, the richer they grow; that the man who steals money out of a shop, provided he expends it all again at the same shop, is a benefactor to the tradesman he robs, and that the same operation, repeated sufficiently often, would make the tradesman's fortune. (J.S. Mill 1968, pp. 47-48)

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[19]This in 1874.

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Bastiat's Legacy in Economics

Jörg Guido Hülsmann

Claude Frédéric Bastiat (1801-1850) is one of the greatest economists ever. His role as organizer of the French, and inspiration of the nineteenth-century continental European free-trade movement is not controversial, and all historians recognize him as a great pamphleteer—some even calling him "the most brilliant economic journalist who ever lived."[1]

It is however not generally recognized that Bastiat was also a significant theoretician whose discoveries have had a lasting importance.[2] His intellectual legacy has been unduly neglected because it concerns problems that are not on the radar screen of twentieth-first-century mainstream economists. It has much common ground with present-day Austrian economics, though, and the purpose of this article is to unearth some of these similarities and to help restore Bastiat to his rightful place in the history of economic science.[3]

Jörg Guido Hülsmann is a Senior Fellow of the Mises Institute. I would like to thank two anonymous referees for their very helpful comments.

[1]Schumpeter (1954, p. 500). For current editions of Bastiat's most important theoretical works, see Bastiat (1964a, 1964b, 1964c, 1983, 1996, 2001). In the present article, I will rely heavily on Bastiat (1851). On Bastiat's formative years, see Paul-Dejean (1997).

[2]Consider Schumpeter's (1954, p. 500) famous dictum: "I do not hold that Bastiat was a bad theorist. I hold that he was no theorist." This seems to have been the death sentence for mainstream research on Bastiat's place in the history of thought. Bastiat is, for example, not discussed in Blaug (1997), Backhouse (1985), Ekelund and Hébert (1990), and Niehans (1990). His contribution to the theory of value is mentioned in Pribram (1983, p. 193) and in a volume edited by Blaug (1986b, p. 56). Blaug's account sums up present-day mainstream opinion among historians of thought. Stating that Bastiat "even sought to provide his liberalism with a theoretical pedigree," most notably through his theory of value, Blaug (1986a, pp. 14f.) maintains: "As an economic theorist, he was third rate."

[3]For other work making such claims, see Hülsmann (2000b) and the following papers published in the volume of the *Journal des Economistes et des Etudes Humaines* celebrating Bastiat's bicentenary: Barmoullé (2001), Thornton (2001), and Lane (2001). These works complement other recent accounts of various Austrian economists that recognize Bastiat as one of their leading precursors but underestimate his theoretical achievements;

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HARMONY VERSUS EQUILIBRIUM

Bastiat is often presented as a champion of the doctrine of harmony. While this is correct, it is generally not well understood what this doctrine actually says and how it contrasts with more recent views about the interrelation of social phenomena.

Bastiat's *magnum opus* bears the telling title *Economic Harmonies*. It is in this book that he develops and defends the thesis that the interests of all members of society are harmonious if and insofar as private property rights are respected or, in modern parlance, that the unhampered market can operate independent of government intervention.

The nub of his argument is a very simple one. He asserts that there is nothing in the *nature* of the free market that would make its well-ordered operation impossible from the outset. In other words, the free market does not *inherently* operate against the interests of any strata of the population. The only group whose interests it cannot possibly reconcile with the interests of all other groups are the impostors or thieves who live off the invasion of other people's property. As Bastiat said about these limits of otherwise universal economic harmonies: "However much we love reconciliation, there are two principles that cannot be reconciled: liberty and coercion."[4]

Thus the free market *can* satisfy all interests except for the interests of those who, for whatever reason, seek to invade the property of others. As a consequence it is not necessary to call for institutionalized intervention. There is of course no guarantee that the market will satisfy each individual at each point of time. Bastiat does not claim that the market would be free from "causes perturbatrices" (pp. 489ff.), that is, from error or violence. Quite to the contrary, he spends many pages of his book emphasizing these features of the social

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see Mises (1985, p. 197), Kirzner (1987), Rothbard (1995, pp. 444ff.), DiLorenzo (1999), and Garello (2001). Other works, although fundamentally sympathetic to Bastiat, entirely fail to grasp his significance as an economic theorist; see in particular Russell (1969) and Roche (1971). Significantly, French contemporaries or near-contemporaries of Bastiat, such as Molinari (1851), Paillottet (1851), Fontenay (1881), and Bidet (1906), usually saw in him a great contributor to economic science, although their accounts focus on less technical aspects than the present work.

[4]Bastiat (1851, p. 12; my translation). The quote shows that Schumpeter (1954, pp. 440, 500) was wrong in asserting that Bastiat put "exclusive emphasis upon class harmony." Bastiat in fact followed Charles Dunoyer and other early nineteenth-century French economists who had blended Quesnay's harmony doctrine with a new doctrine of class antagonism, namely, the antagonism of the political class and the industrial class (see Liggio 1977, Raico 1977, and Weinburg 1978). What set these so-called *industrielistes* and Bastiat apart from Ricardo, Saint-Simon, and Marx was not the stress on class antagonism per se, but their different views on the concrete manifestations of class antagonism. Whereas Ricardo and the socialists held that there were antagonisms inherent in the free market, Bastiat and the *industrielistes* stressed that conflicts of interest were endemic only to political action.

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world (see, for example, 1851, pp. 494ff., 554ff.). His point does not refer at all to the question of whether all members of society always *act* in harmony with each other, but to the question whether their *interests* are always harmonious. Bastiat denies the former, but affirms the latter. The interests of all members of society are harmonious as long as they respect each other's property, deriving from self-ownership, because cooperative production is more physically productive than individual production.[5] Each member of society can profit from a well-ordered division of labor, and there is nothing in the market that would make such a division of labor from the outset impossible.

In making the case for the harmony of interests in the free market, Bastiat argued on a rather fundamental level in order to confront a large and diverse group of intellectual opponents all at once. He did not confine himself to discussing each proposal for government intervention on its own merit, but addressed the common premise of all these proposals, namely, the premise that in an unhampered market some interests are *inherently* antagonistic.

Bastiat analyzed many such alleged antagonisms of interest in detail, proving in each case that the allegation is unfounded. For example, although debtors and creditors seem to have conflicts of interest, this is not really so because a debtor himself has an interest in the well-being of his creditor, lest he would be unable to obtain further credits. And a creditor himself has an interest in the well-being of his debtor because only a healthy debtor can pay interest. Bastiat discussed countless similar relationships, such as those between consumers and producers, proletarians and owners, workers and capitalists, rural and urban population, citizens and foreigners, landowners and residents, the people and the bourgeoisie, etc. He also refuted Malthus's population theory, according to which population growth must bring about food shortages and, hence, end up in conflicts of interest between the members of society.

Virtually all of the arguments he made in regard to these specific issues penetrate to the heart of the matter. For example, in dealing with the proposal to prevent unfair competition by equalizing the conditions of production, Bastiat (1964b, pp. 29f.) observed:

> To equalise the conditions of production is not only to obstruct exchange to some extent but also to attack exchange at its very foundations; for exchange is based precisely on the diversity, or, if you prefer, on the inequalities of fertility, skill, climate, and temperature, that you are seeking to eliminate. . . . At the race track, if one of the horses wins the prize, the other loses it; but when two horses work to produce something useful, each will produce an amount in proportion to his strength; and although the stronger will render the greater service, it does not follow that the weaker will render none at all.

[5]Mises (1998, pp. 158ff.) later stressed this point in discussing the law of association.

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Bastiat's case for the free market was however not only based on refutations of individual government interventions, but also on a general refutation of the common premise of all proposals for government action. He brilliantly argued that all these proposals involved some variant of the claim that the free market by its very nature antagonizes the interests of certain individuals or groups. This is the great subject of his unfinished *Economic Harmonies*. In the preface, which he addressed to the Youth of France, Bastiat (1851, p. 3; my translation) stressed that

> What sets the various socialist schools . . . radically apart from the school of the economists is not this or that question of detail . . . ; it is the point of departure, it is this preliminary and paramount question: Are human interests, left to themselves, harmonious or antagonistic?

A brief look at the history of twentieth-century economic thought confirms Bastiat's insight into the common denominator of interventionist schemes. The most important economic justifications for government intervention stressed the existence of business cycles, monopoly, public goods, and unemployment. In each of these cases, the perceived problem was claimed to be a market failure, which is nothing else but the claim that the problem under consideration springs from the very nature of the market. The market cannot possibly solve it, at any rate, it cannot solve it as well as the government, the great *deus ex machina*, which is therefore necessary to bring relief.

True to Bastiat's spirit, many Austrian and a few mainstream economists have again and again rebutted these twentieth-century allegations of market failure case by case. These rebuttals would certainly gain in strength if they were combined with a more general attack on the fallacy underlying all these individual cases. And when it comes to such endeavours, present-day economists will benefit very much from the careful study of Bastiat's doctrine of economic harmonies.

It is noteworthy that Bastiat's economic-harmonies argument contrasts sharply with the typical twentieth-century argument for the free market, inspired by Léon Walras's work, according to which the market would reach or tend to reach equilibrium, or that it would maximize or tend to maximize social utility. Thus consider how, some decades later, Louis Rougier (1938, p. 70; my translation) puts the scientific case for the free market:

> Economic science demonstrates that the maximum satisfaction for trading partners is realized in a regime of free competition. In the exchange of one single product, the free play of demand and supply alone permits to derive the equilibrium price from the great number of individual bargains–the price for which the quantity of a product offered on a market will be best sold in its entirety, given a certain distribution of purchasing power among the members of society at a given point of time.

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This type of argument was widespread in the 1930s and still is today, thanks to the efforts of free-market Chicago economists. In distinct contrast, Bastiat did not claim that laissez-faire was bound to produce a state of perfection. His contention was that, where private property is respected, a natural order comes into existence in which individual interests are not antagonistic but mutually supportive. Society then constantly progresses, even though it might never be perfect at any point of time.

The Analytical Significance of Property and Appropriation

We have already referred to Bastiat's insight that economic harmonies depend on certain forms of appropriation, namely, on the forms of appropriation constitutive of the free market. Bastiat clearly saw that coercive appropriation—or invasion, as the late Murray Rothbard would call it—brings about an irreconcilable clash of interests, which disturbs and ultimately destroys the operation of the market. His main contribution to positive economic analysis consists in a sophisticated description of the sources and effects of the *disruptions* occasioned by coercive appropriation. "Protectionism," that is, special-interest policies under the mantle of the law, disrupts the natural harmony of interests and creates conflicts over privileges that end up in socialism and war. For example, a tariff on wine benefits domestic wine producers at the expense of domestic consumers and foreign wine producers.

Because government intervention creates winners and losers, the disadvantaged groups have an incentive to defend themselves by gaining control of the government and using it to their benefit, thus further perverting the law. Once protectionism is accepted as a principle, it sets in motion a process that entirely destroys the providential private property order, ending up in full-blown socialism. The main instrument in this process is the perversion of the law:

> It is in the nature of men to react against the iniquity of which they are victims. When, therefore, plunder is organized by the law for the profit of the classes who make it, all the plundered classes seek, by peaceful or revolutionary means, to enter into the making of the laws. . . . Until that time, legal plunder is exercised by the few against the many, as it is among nations in which the right to legislate is concentrated in a few hands. But now it becomes universal, and an effort is made to redress the balance by means of universal plunder. Instead of being abolished, social injustice is made general. As soon as the disinherited classes have obtained their political rights, the first idea they seize upon is not to abolish plunder, . . . but to organise a system of reprisals against the other classes that is also injurious to themselves.[6]

[6]Bastiat (1964a, p. 55; also 1851, pp. 105ff.). In the twentieth century, the dynamics of interventionism have been a favorite subject of Austrian economists. See in particular Mises (1977) and more recently Ikeda (1997) and the literature quoted there.

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Unfortunately, most people lack economic education and are therefore liable to regard such government interference, not as an act of plundering some people for the benefit of others, but as a source of enhancing the wealth of all. For these people, as Bastiat (1964a, p. 144) would say, the "state is the great fictitious entity by which everyone seeks to live at the expense of everyone else."

Bastiat's writings on the dialectics of the providential private-property order and man-made law make him an important forerunner of today's academic discipline of law and economics, even though he approaches this subject from a completely different angle than the mainstream in the contemporary economics profession. Bastiat emphasizes the crucial point that, since law is a man-made institution, it can also be perverted by using it for other purposes than the protection of private property.

Bastiat thus used property and appropriation as fundamental elements of his analysis—they were starting points of his reasoning rather than mere tools for the practical implementation of the results of his reasoning. It was precisely this method that rendered his case for laissez-faire odious to Cairnes (1965), Jevons (1968), and other British economists, and also to the new generation of French economists that filled the new chairs of political economy in the last quarter of the nineteenth century (see Salerno 2001). In their eyes, Bastiat's method involved a *petitio principii*—it presupposed something to be true that could be substantiated only at the end of the analysis.

But this objection missed the point. Bastiat did not argue from the hypothesis that this or that property right was in fact given, or from the postulate that it should guide public policy; rather he engaged in a comparative analysis of two radically different forms of appropriation—property and spoliation, or creation and theft (1851, pp. 220, 502)—and the comparative effects of creation versus theft exist irrespective of which one of them comes to be realized in the economy under consideration.

Contra Cairnes and his other later critics, then, Bastiat's conscious analytical use of property and appropriation was perhaps his most significant contribution to economic science, but the scathing criticism of the later British and French authorities in political economy discouraged virtually all succeeding economists from following in his footsteps. When Murray Rothbard in the early 1960s and Hans-Hermann Hoppe in the late 1980s started reviving this method, they did so almost from scratch and without reference to their great French predecessor.

Human Action, Property, and Value

In Bastiat's thought, property plays an eminent role not only in the analysis of government intervention, but also in value theory. Unfortunately, virtually all of his thoughts on the relationship between property and value are developed in his unfinished *Economic Harmonies* (in particular, in the chapters dealing

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with exchange, value, and property), on which he worked at his deathbed and which is therefore characterized by an almost feverish, repetitive insistence on some few crucial facts that sustain his argument. The following exposition will put these facts in their overall context. According to Pellissier-Tanon (2001), the most detailed presentation of Batiat's value theory is in Gonnard (1941, pp. 338ff.).

The first thing to notice is that Bastiat confines his analysis of value to market phenomena. When he uses the word "value" he means an exchange ratio established on the market. Thus from the outset, the scope of his analysis is more limited than the one of modern marginal-utility analysis, which also uses the expression "value" in a completely different sense. It goes without saying, however, that the different terminology does not per se count against Bastiat or demonstrate a contradiction between his value theory and the modern value theory.[7]

The central proposition of Bastiat's value theory is the bold characterization of market exchange ratios as ratios of human services (Bastiat 1851, p. 118). Again and again he asserts that value is the relationship between two services exchanged on the market and that, moreover, only human services have value, whereas the services of nature are always gratuitous.

These positions seem to be irreconcilable with modern marginal-value theory, which explains market prices in terms of consumers' choices. But as we shall see, Bastiat's theory of services and values relates to market prices in a way that is not at all covered by modern value theory. The latter seeks to explain the exact ratio at which things are exchanged on the market, but this is not at all Bastiat's concern.[8] His main interest is in explaining *what* people

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[7]Bastiat in fact agreed with Condillac's and Say's point that each partner in a market exchange profits from the interaction. Yet in his eyes, this formal characteristic of all market exchanges—he called it a truism—cannot explain why these exchanges come into existence in the first place (see Bastiat 1851, pp. 81, 122). The true explanation is that cooperative production is more physically productive than isolated production (see Bastiat 1851, pp. 86f. 97). Ludwig von Mises (1998, p. 144) has taken essentially the same stance, stressing the central importance of this point in the following words:

> The fundamental facts that brought about cooperation, society, and civilisation and transformed the animal man into a human being are the facts that work performed under the division of labour is more productive than isolated work and that man's reason is capable of recognising this truth. But for these facts men would have forever remained deadly foes of one another, irreconcilable rivals in the endeavours to secure a portion of the scarce supply of means of sustenance provided by nature.

[8]This also sets him apart from Carey (1965, pp. 7ff.) who, while maintaining a similar theory, was primarily interested in explaining the concrete quantities exchanged on the market. In light of modern value theory, it goes without saying that Carey's attempt to derive market prices from prospective labor-service costs is futile.

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exchange on the market, and his answer is that they exclusively exchange human services. As we shall see, this answer not only is entirely correct as far as it goes, but also provides a missing link between the modern economic theory of value and prices on the one hand, and the modern libertarian theory of property on the other hand.

For the understanding of Bastiat's value theory, it is crucial to realize that he uses the word "service" in a completely different sense than modern economic science, namely, in the narrow sense of *human* services or, more precisely, in the sense of human actions performed in the service of other people. In his eyes, political economy is a science of human action, and therefore it must be "based on the manifestations of our *activity*, on the *efforts*, on the reciprocal *services* that are exchanged against one another, because they are susceptible of being compared, appreciated, *evaluated*, and which are susceptible of being *evaluated* precisely because they are exchanged against one another."[9] By contrast, needs and satisfactions are unsuitable as foundations for economic science because these phenomena are bound up with each individual and therefore are incommensurable.[10]

Moreover, and equally fundamental, Bastiat argues that people do not merely serve one another through actions that are performed in the near or more remote future, but also through actions performed in the past (Bastiat 1851, p. 233). Thus one delivers a service not only in cutting another person's hair, keeping someone else's business accounts, or giving a piano lesson, but also in surrendering a piece of land that one has previously transformed by one's own hands, or in surrendering a cake that one has previously baked. In the case of the land and the cake, one's past services do not come alone, but "mixed with" the natural resources that they have transformed.

This use of language might be uncommon, but it is certainly not incorrect as far as it goes. Today we are used to speaking of services in the more restricted sense of labor services that are valued and priced independent from the complementary factors of production used in providing the service. For example, the work of the secretary is a service, but not the pen or the computer that is used. By contrast, from Bastiat's point of view, the provision of each of these factors of production is a service: the secretary provides a service in working, the pen producer provides a service in surrendering the pen, and the computer manufacturer provides a service in surrendering his computer. And the entrepreneur provides services to all these factor-owners in surrendering money to them in exchange for the services he receives. It therefore makes perfect sense to characterize Bastiat's market exchanges as exchanges of services.

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[9]Bastiat (1851, p. 117; my translation; emphasis in original). Notice Bastiat's anticipation of the concept of demonstrated preference.

[10]Ibid. This argument is an interesting anticipation of the twentieth-century case against interpersonal comparisons of value.

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The importance of this characterization of market exchanges derives from its similarities with the Lockean-Rothbardian theory of appropriation and property.[11] According to John Locke's theory of appropriation—which was the standard theory in Bastiat's circle[12]—one owns a piece of land if and insofar as one has transformed it by one's actions. In exchanging this land on the market, then, one surrenders one's past actions—that is, speaking now with Bastiat, one's past services—for a price, which is itself of necessity either an action or a past action mixed with some natural resource. Thus we see that Bastiat's value theory is nothing but a consistent application of the Lockean insistence on the relationship between property and human action to economic theory.[13]

Austrian economists such as Mises (1998), Rothbard (1993), and Hoppe (1989, 1993) routinely stress that exchange and market prices are based on property. There are no things, they observe, that exchange themselves against one another, as in the Walrasian general-equilibrium approach; rather, all market exchanges take place between human beings, and in all market interactions human beings exchange property. For example, when Brown exchanges an apple for a pear from Green, the apple must be Brown's property and the pear must be Green's property, or no exchange could take place. Now, Bastiat's analysis of exchange and value complements and reinforces Austrian price theory by arguing that, ultimately, all pieces of one's property are past, present, or future actions.

Based on this insight, that what we pay for in market exchanges are but the actions of other persons, Bastiat develops a sophisticated analysis of the relationships between value on the one hand, and the joint operation of human action and natural resources on the other.

Bastiat (1851, p. 122) stresses that the utility of the services of natural resources must be strictly distinguished from the utility of human services. Only the utility of human action is related to property and value, whereas the utility of natural resources is not. The utility of nature has, therefore, no

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[11]Murray Rothbard failed to recognize these affinities because he completely misunderstood the meaning of "service" in Bastiat's thought, to which he gave a modern reading: "Bastiat made an important contribution to economic theory by pointing out that *all* goods, including material ones, are productive and are valued precisely because they produce immaterial services" (Rothbard 1995, pp. 445f.).

[12]See for example Comte (1834), Thiers (1848), Molinari (1849), Faucher (1851), Wolowski and Levasseur (1884), and de Nouvion (1905). On Thiers's property economics, see Stiebler (1999).

[13]As is well known, Karl Marx was engaged in a similar, but fundamentally flawed enterprise. He too tried to derive the value of a good from the labor used to produce this good. But whereas, for Marx, the value of a good was a mystical *substance* deriving exclusively from the labor used to produce it, in Bastiat's eyes its value was the observed *relationship*—established by the mutual consent of trading partners—between the labor used to produce it and the labor used to produce the service for which it is exchanged.

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impact on prices, which are determined exclusively by the utility of human action (1851, p. 158). In other words, both human action and natural forces produce useful effects, but one pays only for the utility derived from human action, whereas one never pays for the utility of nature. The latter is always gratuitous, in the sense that it is available for anyone who takes the pains to pick up or "collect" the unowned resources. Says Bastiat:

> From the previous chapters, in particular from the one in which we dealt with Utility and Value, we can deduce the following formula:
>
> *Each man enjoys* GRATIS *all the utilities delivered or elaborated by nature, provided he takes the pains to collect them or to render an equivalent service to those who render him the service of taking these pains for him.* (1851, p. 217; my translation; emphasis in original)

Moreover, because human beings constantly strive to increase the physical productivity of their labor through inventions, the division of labor, the accumulation of capital, etc., and because they can do so only by channeling ever more natural forces into their productive ventures, the value of products—that is, their price in terms of past, present, or future actions controlled by the purchaser—constantly diminishes (Bastiat 1851, p. 241). "What happens if a work instrument is used? That utility is more easily collected. Hence, the service [of collecting the utility] has less *value*. Ever since the invention of book printing we certainly pay less for books—an admirable and misunderstood phenomenon!" (p. 153).

Hence, in a progressing society characterized by the increase of technological knowledge, the accumulation of capital, and other factors increasing the physical productivity of human action, all human beings enjoy ever more utility at an ever lower price. In such a society, one always pays for the utility provided through the services of other human beings, but one only pays for this utility, whereas the ever increasing utility derived from the stronger involvement of natural forces comes for free. Irrespective of individual merits, therefore, each member of a progressing human society benefits from the increase of the physical productivity of the labor of any other member of society. These unearned, gratuitous benefits add to the equally gratuitous general conditions of welfare, such as oxygen, gravity, sunshine, etc., which are equal for all individuals. As the availability of these gratuitous utilities increases, the relative importance of the utilities that have to be paid for—namely, the utilities derived from human action—constantly diminishes. Bastiat called this phenomenon the "progressive community" of all human beings, emphasizing again and again: "It is not the ensemble of values that has diminished, but the ensemble of utilities that has increased. It is not the absolute domain of property that has been reduced, but the absolute domain of the Community that has been enlarged" (p. 231; my translation; emphasis in original).

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Counterfactual Analysis

Bastiat grasped that his analysis of the destructive effects of appropriation by invasion relied on a rather special type of comparing laissez-faire and interventionism, namely, on counterfactual comparisons. In his great essay "What is Seen and What is Not Seen," Bastiat presented this insight as a counterfactual tale about a broken window. A boy breaks a pane of glass and the usual economic sophists gather to praise the accident because it keeps industry going. Bastiat (1964a, pp. 2f.) objects:

> Suppose that it will cost six francs to repair the damage. If you mean that the accident gives six francs' worth of encouragement to the aforesaid industry, I agree. I do not contest it any way; your reasoning is correct. The glazier will come, do his job, receive six francs, congratulate himself, and bless in his heart the careless child. *That is what is seen.*
>
> But if, by way of deduction, you conclude, as happens only too often, that it is good to break windows, that it helps to circulate money, that it results in encouraging industry in general, I am obliged to cry out: That will never do! Your theory stops at *what is seen.* It does not take account of *what is not seen.*
>
> *It is not seen* that, since our citizen has spent six francs for one thing, he will not be able to spend them for another. *It is not seen* that if he had not had a windowpane to replace, he would have replaced, for example, his worn-out shoes or added another book to his library. In brief, he would have put his six francs to some use or other for which he will not now have them.

Here is the counterfactual nature of economic argument in a nutshell. In fact, the very title of the essay, "What is Seen and What is Not Seen," summarizes the point. F.A. Hayek (1964, p. ix) said in just admiration: "No one has ever stated more clearly in a single phrase the central difficulty of a rational economic policy and, I would like to add, the decisive argument for economic freedom." Conscious that he had hit scientific rock-bottom, Bastiat subtitled the essay "political economy in one lesson"–in virtual anticipation of Henry Hazlitt's classic 1944 book that had almost the same title, sold more than one million copies, and, as its author acknowledged, did nothing but apply Bastiat's point to a wider range of economic problems.

Bastiat's nineteenth-century admirers have very perceptively noticed his net departure from the type of argument cherished by the British school of Smith and Ricardo. His biographer Fontenay (1881) observed that Bastiat in a way continued the research program of the physiocrats. The latter had seen human happiness as the object of economic science, which in turn was for them the science of natural law. By contrast, the British classical economists had reduced economics to a science of (visible) facts and replaced human happiness by a materialistically conceived "wealth." Bastiat's great achievement,

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according to Fontenay, was to integrate these two approaches into a "science of the facts from the point of view of natural law"—that is, the natural law determining exchange, value, and property.

Unfortunately, this perspective on the nature of economic laws blossomed only very briefly—most notably in the work of Courcelle-Seneuil (1867)—before it fell into oblivion. Bastiat was defamed as a political agitator and his scientific achievements were systematically belittled.[14] Economic science came under the sway of British political economy, which, as far as its materialistic methodology is concerned, found its fulfillment in twentieth-century positivism. And, last but not least, Bastiat's insights about the essential relationships between the factual or visible parts of human action on the one hand and the invisible or counterfactual parts of human action on the other were replaced by a distinction more congenial to the positivistic mindset, namely, by the distinction between the short run and the long run. The invisible consequences of an action were interpreted as its long-run and thus not-*yet*-visible consequences.

It looks though as if Bastiat himself was not fully conscious of the nature of his argument. On the one hand, he had hit the same nail already in a previous essay, denouncing the *post-hoc-ergo-propter-hoc* fallacy (1964b, pp. 187ff.). On the other hand, even in some passages of "What is Seen and What is Not Seen," he fell back into the short-run-long-run distinction, for example, in the section on thrift and luxury, which he concludes with the statement:

> Morally, the superiority of thrift over luxury is incontestable. It is consoling to think that, from the economic point of view, it has the same superiority for whoever, not stopping at the immediate effects of things, can push his investigation to their ultimate effects. (Bastiat 1964a, p. 47)

However, these inconsistencies were not decisive for the subsequent neglect of his work. The crucial factors were the materialistic-positivistic prejudices underlying the approach of the British classical economists. The latter's unwarranted a priori notions about the nature of economic science prevented Bastiat—along with other important continental European economists—from gaining wider recognition in the Anglo-Saxon countries and thus, as things stand today, among students of economics worldwide. To this day, these prejudices have prevented an adequate reading of "What Is Seen and What Is Not Seen." Most readers infer from the essay that certain economic arguments involve comparisons, but few readers have grasped that these arguments are based on comparative economic laws, and in particular that these comparative laws are counterfactual in nature. This is truly ironic given that the essay

[14]British economists and the men who later filled the new government-financed chairs of political economy in France played the major roles in this anti-Bastiat campaign; see Salerno (1988, 2001).

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is so widely known among economists. Bastiat's early death prevented him from explaining the logical structure of his argument in more detail and generalizing his findings. Future research based on his approach will thus no doubt yield a rich harvest.[15]

Conclusion

We have discussed four areas in which Frédéric Bastiat has made important contributions to economic theory. These contributions have had lasting value and are liable to enrich current research in the Austrian tradition. Bastiat's great themes—harmony rather than equilibrium, property versus spoliation, and property and value—have been almost completely neglected in professional economic science during the unfortunate twentieth century. It is therefore time to return to the works of this genius and to build on some of the foundations he has laid.

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[15]For recent research dealing with the scope and nature of counterfactual laws, see Hülsmann (2000a, 2001).

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REVIEW ESSAY

THE EVOLUTION OF AUSTRIAN ECONOMICS: FROM MENGER TO LACHMANN. BY SANDYE GLORIA-PALERMO. LONDON AND NEW YORK: ROUTLEDGE. 1999.

PETER LEWIN

Although this is a short book, 183 pages inclusive of index and bibliography, it covers a lot of ground. Drawing on her doctoral dissertation, Sandye Gloria-Palermo has undertaken a history-of-thought survey of the Austrian tradition from Menger to Lachmann. In the process, she considers the works of Böhm-Bawerk, Wieser, Mises, Hayek, Rothbard, Kirzner, and Lachmann–a tall order, to say the least. In order to accomplish this task she has chosen to narrow her focus to one central theme. "[I]nstead of concentrating on researching the originality of the Austrian tradition *in its widest sense*, we shall limit ourselves to emphasizing the *Mengerian essence*" (p. 3). Indeed, the whole book is an exercise in determining how these theorists mentioned above measure up when judged in terms of the standards set by Menger and how they are likely to contribute to the development of a viable and valuable Austrian research program going forward. Gloria-Palermo's interpretation, both of Menger and of his disciples, is likely to be controversial among Austrian scholars. I shall indicate some instances where I believe her conclusions are misleading and unwarranted. And I shall indicate where others might find her assertions problematic. This should not, however, be taken to detract from my admiration of the impressive scholarship that this work contains.

The book contains four parts comprised of eleven chapters and a conclusion. Part one (chaps. 1 and 2) lays out Menger's seminal contribution. Part two (chaps. 3, 4, and 5) indicates how Menger's earliest well-known disciples departed from his vision and how, because of the way the literature evolved, Menger's originality was lost. Part three (chaps. 6 through 10) chronicles the contributions of later generation Austrians–Mises, Hayek, Rothbard, Kirzner, and Lachmann. Each is judged in terms of his proximity to Menger's original

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subjectivist vision and method. It is with the work of Ludwig Lachmann that we are seen to have come full circle (after some damaging detours), back to Menger's vision and to an approach that holds the greatest hope for a modern Austrian revival that so far seems to have hit a dead end. How to escape from this dead end is the subject of the remaining two chapters and the conclusion (in part four). Gloria-Palermo sees in Lachmann's approach the ingredients of a progressive research program if only the modern Austrians can escape from the potential nihilism that seems to be implied by it, and if only they can rid themselves of their untenable commitment to both "strict" (sic) methodological individualism and to the belief that the "efficiency" of free markets is implied by their economics. In what follows, I will first outline briefly the substantive content of the survey chapters, highlighting some of the more interesting interpretations; I will then turn to a critical examination of the assertions mentioned in the preceding sentence.

Gloria-Palermo identifies the essence of Menger's originality as being his subjectivism and its implications for time and uncertainty. Unlike the classical and neoclassical economists, Menger is not concerned about static resource allocation, but rather about resource use as a result of a better knowledge of production processes. He was also a pioneer in his understanding of the role and importance of institutions in economic life. It was unfortunate then, as has of course been noted by others (most notably William Jaffé), that he has tended to be lumped together with Jevons and Walras as one of the founders of conventional marginalism. Indeed, using the work of Carl Menger's son, Karl Menger, and the well-known letters that Menger wrote to Walras, Gloria-Palermo expounds upon the very real differences in Menger's conception of marginal valuation and why this necessarily implies that Walras's calculus-based mathematical conception was flawed. Some might feel that the distinction made between the different conceptions of marginal utility has been overstated (resting as it does on the difference between discrete and continuous changes), but this is not the place to pursue that possibility. Suffice it to say that Karl Menger's discussion as reported on by Gloria-Palermo is interesting and worthy of further consideration.

While Walras is concerned with equilibrium, Menger is concerned with processes. Production occurs in real time, and this implies the need to anticipate the future, which is uncertain. The production process is characterized by various types of uncertainty. The desire to hold money as a reserve should be seen in this light. Gloria-Palermo speaks here of Bergsonian uncertainty and evokes Lachmann's axiom: "as soon as we permit time to elapse, we must permit knowledge to change" (p. 31). While it may be true that this conception is implied by Menger's work (as indeed Lachmann was to vigorously argue), it cannot be claimed that Menger fully understood this. In her zeal to establish Menger's originality it may well be that Gloria-Palermo is making him too much of a subjectivist. So much is suggested by Lachmann's own

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analysis of Menger's incomplete subjectivist revolution (Lachmann 1978b). Menger had not arrived at the "dynamic subjectivism" (O'Driscoll and Rizzo 1996) that characterizes the current Austrian revival.

Be that as it may, there is no doubt that Menger made a significant subjectivist turn, and Gloria-Palermo considers perhaps his most famous disciple, Eugen von Böhm-Bawerk, to have abandoned this approach. She makes use (without citation) of the famous quote that Schumpeter has attributed to Menger to the effect that Böhm-Bawerk's theory of capital was his "greatest error." Though a common belief, it has, to my knowledge, never been firmly established that Menger actually said this, or, for that matter, what exactly he meant. The following would thus seem to be somewhat speculative and, at least, in danger of overstatement: "Böhm-Bawerk expresses his indebtedness whilst explicitly asserting his loyalty to Menger. However, the result of his investigations–the theory of capital and interest–turns out to be *violently rejected* by Menger himself" (p. 39, italics added)

That there are problems with Böhm-Bawerk's theory of capital and interest from a subjectivist point of view is not to be denied–specifically his "objectivist" approach to the measurement of capital and his allegedly circular justification of positive time preference.[1] I would suggest, however, that Böhm-Bawerk's contribution, even to the purely subjectivist aspects of Austrian economics, is not so easily dismissed.[2] Böhm-Bawerk's capital theory has both Austrian and Ricardian aspects to it and has been a source of inspiration to both literature streams. His essential insight about the productivity of wisely chosen "roundabout" methods of production comes from Menger's framework of higher- and lower-order goods. It is an original insight that no one has disputed and that Lachmann (ironically for Gloria-Palermo's case) considered essential to his (Lachmann's) subjectivist theory of capital. Similarly, Böhm-Bawerk's pure time preference theory of interest is pathbreaking and is definitely subjectivist in nature. It is underappreciated to this day.[3] Nevertheless, Gloria-Palermo is surely correct in claiming that Böhm-Bawerk's work had a neoclassical interpretation that theorists have used to absorb him into that literature stream. She might have noted that the same can be said of his work at the hands of the neo-Ricardians. This is, however, well known and well documented and one may doubt that it is sufficient warrant to revise our opinions of Böhm-Bawerk as a theorist of the highest order, even from a subjectivist point of view (though he may at times have strayed).

If Böhm-Bawerk is the unexpected villain of her piece, Gloria-Palermo considers Friedrich von Wieser to be a minor hero–the one who was faithful to Menger's subjectivist insights and the one whom (in stark contrast to

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[1]Mises and Rothbard would add to this his unsatisfactory "psychological" approach to the question of time preference. For a discussion see Lewin (1997a) and Pellengahr (1995).

[2]See Lewin (1999) for in-depth discussion that benefits from discussions by Lachmann (1978a) and Kirzner (1966).

[3]See Lewin (1997a) and Pellengahr (1995).

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Böhm-Bawerk) history has treated unjustly. She offers a reconsideration of Wieser's role. Though he is most remembered as the Austrian who examined the imputation problem, a contribution that led him to be associated with the formalist question of the existence of general equilibrium, he might just as well have been remembered as the author who sought "to develop a general theory of social evolution based on power conflicts between various categories of economic agent" (p. 52). Indeed, it is the latter project that was Wieser's main focus and his discussion of imputation in a static world was merely transitionally instrumental in this more ultimate and comprehensive goal. Wieser is known as a "theoretician of value" but is more accurately thought of as a "theoretician of socioeconomic dynamics" (p. 53). That he did not receive the recognition he deserved, and that his work did not provide the impetus for further development along the lines he originated, was most likely due to a disapproval of his radical ideology. "His clearly interventionist political stance turns out to be an explicit expression of praise for fascism" (p. 54). This is a pity because what is interesting about Wieser is the way he "merges an economic theory of value and a social theory of power" (p. 54). Modern Austrians, with their inappropriate "libertarian leanings," have overlooked the real contribution that lies below the repugnant ideology.

According to Gloria-Palermo, Wieser has an interesting theory of social evolution that incorporates the concept of power and that should have been considered by the later Austrians.

> In Wieser's view, efficient institutions do not automatically have a spontaneous or organic origin. Indeed, the author introduces a pragmatic dimension through the role given over to leaders in the process of building an economic and social unit. Institutions (money, market, division of labor) are neither the result of an organized social will nor the unexpected result of individual interaction: "much more satisfactory is an explanation based on gradual historical evolution, which takes into account the powerful factor of time." (p. 57, quoting Wieser 1967, p. 163)

Gloria-Palermo makes a good case concerning the relative lack of knowledge among Austrian economists concerning this aspect of Wieser's work, and particularly its relationship to Menger's theory of institutions. I was left with the feeling that she might have done well to have developed it further—perhaps this is a project for the future.

Though Wieser is celebrated by the Austrians for his discussion of the problem of imputation, it is this that is actually responsible for the Austrian originality being absorbed into neoclassical logic.

> In the ideal system of the simple economy, the principle governing the relations between evaluation is that of marginal utility. In such a case (static framework, perfect information, rational agents), the concept of evaluation is no doubt of the same nature as for marginalists. Limiting Wieser's analysis to this aspect of his work, that is, to the first phase of his work, makes of him an author with no originality, compared to a marginalist movement in full swing. (p. 58)

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Gloria-Palermo includes here a discussion of the Viennese philosophical environment of the time and how this was conducive to the emergence of general equilibrium as the prime focus of economists. The triumph of formalism led naturally to the emergence of the general equilibrium paradigm and general equilibrium seems like a natural solution to the imputation problem. In this context it is simply an accounting problem. As she points out, however, when one moves away from the static world of general equilibrium into a world of interdependent action, where the functional structure of simultaneous determination is dropped in favor of a causal structure, the question of imputation has great social relevance. Indeed, she might have noted that this realization has of late penetrated the discussion of economic organization in the question of how to monitor and reward the individual contributions of team members in a joint production process.[4] The imputing of value is an inseparable part of the institutional structure governing the social relations between the owners of factors of production in any production process. It is of some interest to know that Wieser had anticipated these dynamic and institutional aspects of the imputation problem even if the answers he gave might not always have been to the liking of his modern Austrian progeny.

In her discussion of "Menger's legacy" in part three, Gloria-Palermo concludes that the legacy is a mixed one. We see both adherence to and gross departures from Menger in this later generation. Unambiguously in the latter category is the Mises-Hayek theory of the business cycle, which deviates from the essence of Menger in two ways–in the subjectivist dimension (it freezes individual [time] preferences) and in the role assigned to equilibrium. Hayek is particularly blameworthy in placing "the Austrian theory of economic cycles and fluctuations within the continuity of the deviation initiated by Böhm-Bawerk" (p. 73). "[I]n contrast to the Mengerian logic, we have here a totally deterministic process" (p. 75). It all adds up to a rather harsh and unmitigated judgment. One need not be ready to offer a full endorsement of the theory (as I am not) and yet still be able to concede that there may be some elements of valuable truth in the intuition that it offers.[5] As with the criticisms of Böhm-Bawerk, it should be noted that the shortcomings of the Austrian business cycle theory are well known and have been widely discussed in the modern literature. As deterministic as it might be, the theory asks a crucial question: Are inflationary policies bound to be followed by an economic contraction? Many competent theorists, some thoroughgoing subjectivists among

[4]Such concerns can be found in the "New Institutional Economics," in the strategy literature of the "Resource Based Theory of the Firm," and in some modern Austrian discussions of the firm. See Lewin (1999, chaps. 9 and 10) for a discussion.

[5]The modern work of a number of competent theorists who have considered these valuable aspects worthy of a reworking of the theory (Garrison 2000; Horwitz 2001; and Cowen 1997, to mention just three) should be noted.

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them, are inclined to give an affirmative answer. It is not clear that Menger would not have gone along as well.

In Mises's work in general, according to Gloria-Palermo, we do find a reappearance of the Mengerian essence. In his consideration of human action Mises is progressively forced to consider the logical imperatives of time and to reject the static framework. In the debate on socialist planning, Mises becomes clearly aware that he is speaking a different language from the neoclassicals. Similarly, Hayek's lengthy research program brings him to the realization and expansion of the idea that competition is a discovery process, a process of knowledge discovery. Hayek's "knowledge problem," which decisively destroyed the case for comprehensive central planning, clearly arises out of the Mengerian essence. Included in this chapter (chap. 6) is a discussion of the different methodological approaches of Mises and Hayek that is, not surprisingly, critical of praxeological a priorism. There is also a brief but interesting discussion of the relationship between the ideas of Hayek and Popper.

Gloria-Palermo's discussion of Murray Rothbard's work is completely unsympathetic. She considers Rothbard to be quite beyond the pale, not only in that his work departs unacceptably from Menger's essence, but also because it is little more than a transparent "theoretical foundation for new right-wing policies" (p.103). This last-mentioned epithet is particularly unfortunate, given, as I shall discuss below, that our author seems to draw inappropriate policy implications from her own analyses.[6]

She is not quite so critical of Israel Kirzner's theory of entrepreneurial alertness, which she portrays as summarizing the contributions of both Hayek and Mises through two main analytical principles, viz., the concept of human action and the recognition of the problem of knowledge. "Ultimately, then, the kind of 'knowledge' required for entrepreneurship is 'knowing where to look for knowledge' rather than knowledge of substantive market information . . . alertness" (p. 105). It is in his commitment to equilibrium and his characterization of all entrepreneurial action as equilibrating that Kirzner comes up short. His debate with Lachmann on this issue, ongoing in the work of Lachmann's disciples (for example, O'Driscoll and Rizzo 1996), serves to make this plain.

Gloria-Palermo introduces the work of G.S. Richardson (1960) as further critical ammunition.

> The fact that a profit opportunity is clearly identified by alert entrepreneurs as a whole is the very reason for its not being exploited. . . . For the

[6]To refer to a libertarian approach as "right-wing" threatens to seriously limit the book's credibility with American-Austrian and other heterodox readers insofar as it suggests it might be the product of a narrow and parochial European mind, quite unfamiliar (or unconcerned) with the American political spectrum (in which, of course, libertarians do not consider themselves to be "right-wing"). Such an outcome would be most unfortunate given the many valuable insights that the book does contain.

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> principle of competition to operate, Richardson believes that there needs to be an *ex ante* coordination mechanism capable of guaranteeing investment activities. (p. 108)

But it is not so clear to me that Richardson's work (which, it might be mentioned, was inspired by Hayek's work in the 1930s) is damaging to Kirzner's conception of entrepreneurial alertness as such. Rather it might be seen as complementary to it. Kirzner might well argue that some of the *ex ante* coordinating mechanisms, so insightfully illuminated by Richardson, can themselves be understood as the result of entrepreneurial alertness (for example, joint ventures) while others (tacit rules, the helpful "imperfections" of limited expansion capacity, etc.) are the natural outcome of the market process. Still, the discussion of Richardson's work in the context of Kirzner's theory of entrepreneurship is provocative and suggestive.

In further criticism of Kirzner, Gloria-Palermo asks: "Could it not be argued . . . that the interest of the entrepreneur who unearths a non-exploited profit opportunity would be to keep this information private and confidential as long as possible and to exploit information asymmetries?" (p. 115). It is not clear that this is a valid criticism of Kirznerian entrepreneurship. Surely the entrepreneur would not "keep this information private and confidential as long as *possible*" but only as long as *desirable*, in order to set up an appropriate protective institutional structure. It is, after all, a well known and incompletely solved problem that a valuable idea might have to be divulged *before* it can be exploited, when, at the same time, the act of revelation might threaten the expropriation of its potential value. Kirzner is surely right that in these types of matters "markets do work" since it is an undeniable empirical fact that many good ideas do get exploited and that this is more true of free markets than of highly regulated ones. This should not, it seems to me, be conflated with the valid criticism of approaches that seem to suggest that markets always work in a way that is "optimal" or "efficient" as Kirzner has sometimes seemed to be saying, especially when these standards are (sometimes implicitly) borrowed from the very neoclassical paradigm that has been rejected (more of this below).

When we come to a consideration of the work of Ludwig Lachmann we have finally and fortunately a true and faithful disciple of Menger. Lachmann is seen to have both understood the essential Mengerian essence of the subjectivism of value and to have validly and fruitfully extended it to the subjectivism of expectations.

> It is now possible to make an assessment of the condition and the scope for the development of the Austrian tradition as it appears through its modern revival. In fact, the results are relatively negative. Rothbard's loyal path to Praxeology ends up being little more than the theoretical basis for libertarian politics; the theory of entrepreneurship, in its attempt at reconciliation with the neoclassical movement, loses the Mengerian originality related to the concepts of uncertainty and speculation; there remains the path taken by Lachmann. (p. 131)

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Lachmann alone has pursued the implications of subjectivism in full. Like Richardson, he has realized that human action is propelled by subjective interpretations of reality, rather than by a uniform understanding of it. "The absence of a uniform relationship between a set of observable events which might be described as a *situation* on the one hand, and expectations on the other hand, is thus seen to be the crux of the whole matter" (p. 120, quoting Lachmann 1943, p. 14). Since individual expectations differ, implying that at most one of a set of differing expectations can turn out to be correct, error is inevitable. And since action precipitates further error, a convergence toward an equilibrium of fully coordinated plans and expectations cannot be deduced or assumed. For Lachmann, as ultimately for Hayek, such convergence is a complex empirical matter, but whereas Hayek was willing to assume such a convergence, Lachmann was not.

This unflinching confrontation with the implications of "radical subjectivism" has suggested to some the danger of descending into the abyss of theoretical nihilism. Gloria-Palermo takes this prospect seriously and considers possible escape routes in Lachmann's own work. Lachmann (1971) considers how the institutional structure of society evolves to provide individuals with a way to cope with inevitable differences in expectations. He contrasts the necessary durable nature of the institutional order as a whole with the requisite flexibility of the individual institution. And in his 1986 work he discusses the need to develop different theories of market process according to the different institutional environments in which market interactions take place. He suggests reducing the level of abstraction so as to define with greater precision the effect of the institutional context in which individual plans are made and executed. "Is it possible," Gloria-Palermo asks, "to imagine a more precise theory of the market process that allows us to go beyond the simple non-deterministic conclusion reached by Lachmann, whilst at the same time conserving the assumptions of radical uncertainty and subjectivism?" (p. 140) and she sees hope in "an enlarged conception of market process which takes into account both the influence of the institutional environment on the process of plan formation and the evolution of the institutional context as the result of individual interaction" (p. 142).

As someone with a lifelong interest in Lachmann's work, I understand the apprehension that many have felt about his radical subjectivism. Nevertheless, I consider the threat of nihilism to have been dramatically overstated, especially since Lachmann's own work has pointed the way to a rich research agenda along the lines discussed in the previous paragraph. Gloria-Palermo might have taken note of the considerable volume of work bearing the undeniable influence of Lachmann that has developed over the past thirty years. This is, it seems to me, an unfortunate omission from her work, especially regarding her repeated negative judgment concerning the achievements of the Austrian research program. As it is she mentions only the notable work of Richard Langlois. She fails to mention the brilliant analysis of Don Lavoie on

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economic planning (1985), most of the many works of Peter Boettke on culture and institutions (some recently collected in Boettke 2000), the work of Roger Koppl on markets and "big players" (for example, Koppl and Yeager 1996), and of Nicolai Foss and others employing Lachmanian themes in the area of economic organization, just to mention a few.[7]

The notion that Lachmann's insights lead to a theoretical nihilism seems to be predicated on the assumption that an inability to prove convergence to equilibrium implies complete indeterminateness, that we cannot know anything about anything. Surely this is not what Lachmann meant or what his insights implied. I have tried to argue that correctly understood both disequilibrium and prediction are possible (see Lewin 1999, chaps. 2 and 3; 1997b; and also Loasby 1991, 1994). The following assessment thus seems to me to be wide of the mark in a number of different respects:

> If we were to summarize the work of Lachmann in a few words, we would talk of his attempt to extend subjectivist logic to agents' expectations. . . . [T]he implications of this enlargement have far reaching consequences. Lachmann offers an ideal-type view of the market process, at the same time questioning not only the normative Austrian conclusions supporting non-intervention, but also limiting the theorist's field of intervention regarding economic prediction and more generally regarding his capacity to generate general laws and theories. (p. 116)

While it may be true that Lachmann's work questions the ability of theorists to make predictions, or of their ability to generate general laws and theories (though this is more arguable), it is decidedly not true that Lachmann's work challenges the normative Austrian conclusions supporting nonintervention. This is an assertion repeated throughout this work[8] and is one that others

[7]Casting a wider net, the modern Austrian market-process research program has yielded much in recent years. Contrary to Gloria-Palermo's assertions, there are, it seems to me, grounds for guarded optimism. There is a small but very active network of scholars working in this tradition. The products of this work includes many articles published in diverse journals and books (including twenty in the Routledge series on the Foundations of the Market Economy), many papers presented at conferences, and two active journals. This work reflects a shared intellectual heritage and a shared language of intellectual discourse that has been applied to a number of areas of current interest including money and banking institutions, the theory of the firm and economic organization, the transition to market economies, antitrust economics and the economics of standards. In addition, Austrians have continued to write about those areas that have been of traditional interest like methodology and history of thought. References are too numerous to produce here.

[8]"Lachmann's conclusions are quite embarrassing for anti-interventionist supporters" (p. 127); "the Austrian tradition is increasingly aligned with the defense of the free market but it is analytically doubtful that this may be derived from the original scientific program of Menger" (p. 151); "Lachmann's work surely cannot be considered as biased toward an ideological defense of the market" (p. 158); and similarly for Richardson, "Richardson's criticism, although not directly aimed at Austrian competition theory, questions the results of Hayek and Kirzner regarding the market system as a desirable order" (p. 108).

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have made as well. I would argue strongly that Lachmann's work does indeed establish a presumption against interventionism, and one that Lachmann understood. It is in this regard that Gloria-Palermo's interesting survey analysis is at its weakest.

In the first instance, Lachmann's subjectivism complements Hayek's knowledge problem in the decisive case against comprehensive planning. The planners are just as radically ignorant as other individuals in the economy. In the matter of less comprehensive planning, of which interventions of various sorts and degrees are cases in point, the same considerations apply. Regulators are also radically, subjectively ignorant. Their plans, based on their expectations, are as likely to be falsified as any. How, one may ask, does one get from an assertion of radical subjectivism to a support for intervention? The following reasoning seems to apply. Since Lachmann has established that individual expectations must differ, no convergence to equilibrium can be proven. This means that individual action may be paralyzed (especially in free-rider type situations)—it raises the question of whether action is possible in disequilibrium and suggests that when the answer is negative, as it is argued, it well might be,[9] intervention is called for. It progresses from the argument that since the "efficiency" of the market process cannot be proven (an assertion Gloria-Palermo makes frequently), a case for intervention has been made. In other words, there is a failure to distinguish between the assertion that it cannot be proved that the market process is "efficient" and the assertion that the market process is "inefficient." *Acceptance of the former assertion in no way implies acceptance of the latter one.* The market process should not to be presumed to be "inefficient" unless it can be proven "efficient." But even if one were to go this route, a presumption of market "inefficiency" does not, *in itself*, establish a case for government intervention. The latter is only true if greater "government inefficiency" can be excluded. Gloria-Palermo does not address this possibility.

I have assiduously used scare quotes around the word "efficiency" in order to suggest care in its use. The concept is a slippery one, and while space considerations prohibit a full consideration here, I would contend that if it is to have any cogency in this context, it can mean nothing else than that an "inefficient" situation is one that can be "improved" by government intervention of some kind (for further justification, see Lewin 2001). If I am correct, attention must be directed to the question of how an "inefficient" situation could be identified. It is necessary not only to argue that the status quo is somehow "less than optimal," but one must further address the question as to how it

[9]Though, as suggested above, there is much reason to dispute this. The existence of free-rider situations is quite insufficient to establish a case for a government imposed solution—for example, the mandating of a uniform standard. History is full of examples of spontaneous market solutions, the emergence of institutions that internalize these collective gains (see Liebowitz and Margolis 1999 and 2001).

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can be shown that government intervention will improve matters. When the burden is thusly placed the case for intervention is, indeed, a difficult one to make, and the work of the Austrians surely makes it even more difficult, given the type and volume of knowledge that policymakers must be assumed to have in order to achieve their aims, not to mention the reliance one must put on public goodwill in contrast to market incentives.

Finally, Gloria-Palermo suggests that the Austrians have an inappropriate and inconsistent adherence to the principle of methodological individualism. I believe this opinion is predicated on an unwarranted construction of this concept–a belief that is supported by her use in some places of the modifier "strict" as in "strict methodological individualism." Clearly Austrians do not deny the crucial role of existing social institutions in conditioning human action, yet they have not thought this to be in conflict with adherence to methodological individualism. Though groups of individuals (rather than individuals) and institutions may be selected for in evolutionary processes, it still remains true that only individuals can act.[10] Adherence to methodological individualism reflects the belief that any satisfactory explanation of economic outcomes must, as far as is possible, be traced back to the individual actions that brought it about. This surely does not deny that, depending upon the context, certain institutions must be taken as exogenously given. The implicit assumption is that they, in turn, are the result of prior individual actions not part of the current analysis. One cannot trace everything back all the way to the actions of Adam and Eve! This does not mean that one abandons methodological individualistic principles.

Despite these criticisms, I believe this is a valuable and interesting work and one that serious students of Austrian economics and the history of thought should read critically but appreciatively.

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[10]For a discussion see Zywicki (2000).

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YOU DON'T ALWAYS GET WHAT YOU PAY FOR: THE ECONOMICS OF PRIVATIZATION. BY ELLIOT D. SCLAR. A CENTURY FOUNDATION BOOK. ITHACA, N.Y.: CORNELL UNIVERSITY PRESS. 2000.

Elliot Sclar's book *You Don't Always Get What You Pay For: The Economics of Privatization* presents an empirical analysis of privatization that he thinks has been lacking. He uses several case studies to explain the merits and downfalls of trying to privatize "public services." After examining several case studies he concludes that privately producing "publicly provided goods" is not always beneficial to society.

The book is easy to read and the data are clearly presented, but his conclusions are disappointing. Like many mainstream economists, Sclar does not understand market process theory. The book emphasizes two major points. First, that privatization will not lead to greater and more efficient production across the board. He argues that every situation is unique and that the decision to privatize should be made on a case-by-case basis. Second, the conclusion that privatization is the cure for the ills of government services comes from economists and politicians dependent on the standard neoclassical model of competition. According to Sclar, this model is too simple and uncharacteristic of the situations confronting government in its decision to privatize. While I agree with Sclar on the second point, I find myself in disagreement with him on the first point.

There are at least two major problems with the author's framework. First, he defines three types of goods: private, public, and publicly provided. Few economists would disagree with how he defines the first two, and in Sclar's defense, he admits there exist few "pure public goods." However, he defines publicly provided goods as goods that can be produced by the private sector, but where private provision of these publicly provided goods leads to externalities and only more problems for government to solve. Sclar's confusion, like that of most neoclassical economists, occurs because he does not fully understand the problem of externalities. Externalities break down into two types, technological and pecuniary. Pecuniary externalities are numerous but are easily corrected in the marketplace without government intervention. In fact, most externalities are pecuniary and government intervention only makes matters worse. Technological externalities are a potential problem, but like

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pure public goods, there are few if any cases of this type and no government intervention exists to correct them.

The second and more important problem is that Sclar defines privatization as government contracting with private-sector firms to provide a "publicly provided good." This is how politicians and economists commonly define the term, since this method of privatization is the only one that governments have attempted. Austrian economists would agree that this method of privatization is common but also flawed. To discuss privatization in any meaningful sense, one must go beyond government contracting and remove government from the production process completely, returning the assets to private individuals or firms to use, as they desire. Only by restoring private property can entrepreneurs fully function in their capacity of serving the consumer.

I agree with Sclar that the neoclassical view of competition is too naïve to explain the competitive landscape, but it is clear from his presentation of the model that he is no supporter of free markets. "The economic playing field is more realistically conceived as mountainous terrain that includes several high peaks from which well-endowed corporate and individual warriors swoop down to seize targets of opportunity" (p. 9). Clearly, Sclar views the economy as monopolistic with the wealth concentrated in the hands of a few, but nowhere does he explain how these corporations or individuals acquired their endowment or monopolies.

He does not even mention the possibility that success and wealth may be the result of satisfying the desires of consumers. He lacks any understanding of the Austrian view of competition, where both value and cost are subjective and where entrepreneurs compete with each other in a rivalrous manner evaluating the market landscape and risking capital on what they believe to be the best profit opportunities. There is no mention in Sclar's analysis of the consumer being the sovereign in a market economy, or that an entrepreneur can only earn profits by satisfying the demands of the consumer and developing new competitive advantages. Instead, Sclar holds government and the services it provides in high esteem and warns us that we should be hesitant to remove government from the production process. He argues that the services government provides are valuable to society and that it would be unwise to dismantle the welfare state "Because the services provided by these workers remain valuable, the continued public employment seriously impedes the larger laissez-faire goal of shrinking both the size and role of the state in society" (p. 4).

Sclar's analysis of privatization boils down to a "make or buy" decision for the state. In his view, government production is not inherently more or less efficient than competitive markets. Therefore, he reduces the problem to one of management organization rather than economic analysis. In the absence of the alternative of true privatization, there is some merit in his case studies and the many problems he identifies with "contracting out." First, it is not easy to completely identify the service that the private company is to provide in a simple

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contract. Second, how does one judge whether private or public production of a good is better? Third, competition has very little to do with how goods are produced. Fourth, the production of goods and services depends more on the organizational structure of the producer than whether they are public or private. Finally, the solution is not as simple as private or public production, but involves recognizing that you can use both methods to improve public services. Thus, he wants his reader to conclude that we should not privatize or reduce the role of government in the economy, but merely improve the methods of public production.

One obvious problem with his argument is his implicit assumption that all government services are valuable to society. He completely leaves out the entrepreneur–and, more importantly, the consumer–in determining whether a good is valuable or not. He never acknowledges that in the absence of government provision, private companies would fill the void if the good were valuable. Another flaw from the perspective of true privatization lies in his argument that the complexities of government services make defining the responsibilities of the private providers highly difficult. If government truly privatized in the laissez-faire sense, then the expertise and experience would be part of the private sector, and private-sector firms would have every incentive to meet their "responsibilities."

So how does Sclar evaluate whether or not privatization is successful? He argues that the goal should be to reduce the cost of production and that it does not follow that private production automatically reduces cost. The idea that prices provide information to consumers and producers on how to allocate resources is too simple. According to Sclar, there exist additional costs, such as monitoring and contractual costs incurred by the government agency that supporters of privatization fail to recognize. In addition, one must evaluate the costs of the entire agency, not merely the contracted portion. "The state must absorb overhead regardless of privatization. The issue for taxpayers is getting the most output for the money that is spent. Therefore, the correct way to compare in-house work with contracted work is on the basis of avoidable cost" (p. 63). To Sclar, this method of accounting shows the benefits of privatization to be negligible. However, he seems oblivious to the fact that it also suggests that government management and contracting out should be replaced with true privatization, which has all the benefits of private-sector production but without all the monitoring costs and corruption associated with contracting out. Furthermore, the economic cost of redistributing income from the individual to the public sector is never examined. If the cost of producing a good privately and publicly is the same, then the publicly produced good will always cost more because of the economic costs of redistributing wealth.

Sclar thinks that private competition imposes high costs on consumers. For example, in his analysis of the medical industry, he states "We pay a steep price for this competition. In the United States, about 25 cents of every health-care

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dollar is spent on administration and *profits*. In Canada, which has national health insurance, the comparable overhead figure is 15 cents" (p. 92; emphasis added). Neither quality of the product nor implicit costs seem to be of concern to Sclar. The Canadian system of socialized medicine has created shortages, high waiting costs, and the rationing of medical services–exactly the expected consequences of such regulatory practices (Richman 1994). Sclar's remedy would not cure the problem, not because the free market lacks competition as he suggests, but because the contracting remedy does not provide true market incentives. Firms awarded government contracts do not have to satisfy individual consumers who will purchase more or less of the product due to the quality of the product or service. Instead, private firms become de facto public firms that will be paid by the government regardless of the type of service they provide.

Sclar argues that the answer to the public production of goods and services is not the private sector, but the reorganization of the bureaucratic agency.

> For those of us who believe that a responsive and efficient public sector is the lifeblood of a progressive democracy, there is now only one way to move forward; we must embrace the opportunity afforded to us by new organizational forms. Our goal should be to reconstitute and improve how public agencies serve the public. (p. 95)

To show how our economy can reach this lofty goal, Sclar uses a combination transaction cost and institutional view of economics. Austrians would agree that institutional arrangements in an economy are important and while Sclar acknowledges some interesting problems in the area of contracting services such as agent-principle problems, asymmetric information, and moral hazard, he seems unaware of the many ways developed in the private sector to mitigate these problems. He also spends a good bit of time assessing the risk and uncertainty of contracts, but again he ignores the basic economic insight that mistakes in the private sector are costly and not often repeated, but in the public sector such mistakes are rarely corrected so long as taxpayers' money funds the agency. His suggestions that agencies could use incentives to improve performance are weak and unconvincing.

The author points out that contracts between public and private organizations have a history of graft and political corruption and he suggests this corruption is the result of failing competitive forces.

> The core privatization argument is that the pressure of external competition forces internal reorganization. However, market-based competition has little to do with most of the work that most people do everyday. They work more or less productively depending on how well their immediate work environment is structured. (p. 145)

I would argue that this corruption is the result of bringing the private sector into the public fold, and not a systemic problem of competition or organization.

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Sclar's book is a mixture of criticism of the neoclassical model of competition and an argument that politicians and bureaucrats can produce goods and services as well as and perhaps better than entrepreneurs in the private sector. While I agree with him on many of the shortcomings the neoclassical model of competition, his mistakes demonstrate an ignorance of Mises's explanation of the problem of economic calculation and his theory of bureaucracy. In bureaucracy there exists no private property, no profit motivation, and no market prices based upon the decisions of consumers and entrepreneurs. Therefore there is no rational economic calculation, and Mises describes the core problem of bureaucracy very clearly:

> The public enterprise's duty is to render useful services to the community. But the problem is not as simple as this. Every undertaking's sole task is to render useful services. But what does this term mean? Who is, in the case of public enterprise, to decide whether a service is useful? And much more important: How do we find out whether the services rendered are not too heavily paid for, i.e., whether the factors of production absorbed by their performance are not withdrawn for other lines of utilization in which they could render more valuable services? (p. 60)

According to Sclar, solid economic analysis and organizational structure, not ideology, should determine the best means of production. He claims that conservatives and libertarians are too focused on ideology and limiting the size of government that they push blindly for privatization whether or not it is the cheapest means of providing "public services." The contracting approach does indeed have systemic problems and at best may reduce the cost of government, but it is not true privatization. I would contend that the Austrian theory of competition as a market process requires that privatization transfer ownership of resources and responsibilities from government to the private sector to be completely successful. This is not a purely ideological position for smaller government, but one based on sound economic analysis.

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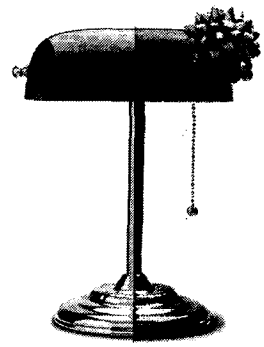

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FROM MUTUAL AID TO WELFARE STATE: FRATERNAL SOCIETIES AND SOCIAL SERVICES, 1890-1967. BY DAVID BEITO. CHAPEL HILL: UNIVERSITY OF NORTH CAROLINA PRESS. 2000.

A common refrain heard from those who criticize recent welfare reforms is that the private sector cannot handle the burdens imposed by the dismantling of the welfare state. Since the passage of the 1996 welfare reform law, the provision of welfare services has become less centralized, devolved to states and local communities. Since the "Charitable Choice" provision of the 1996 law loosened religious restrictions on third-party providers, government contracting with religious groups has become more common. Both major party candidates for president in the most recent election endorsed the practice of contracting with religious groups for the provision of social services.

Yet critics of this decentralization and privatization insist that the private sector is not suited to take on this increasing involvement. The subtext always calls for a perpetuation of federal welfare policies as we have come to know them over the past half-century. Marvin Olasky challenged some of these notions when he published *The Tragedy of American Compassion* in 1992. After then-House Speaker Newt Gingrich touted Olasky's book, placing it on his "required reading" list for incoming members of Congress, Olasky's fame accelerated, as did the fame of the book's premise.

In *Tragedy*, Olasky introduced the idea that prior to the growth of the welfare state in the twentieth century, private individuals and organizations aided the poor in many ways, and that they did so more effectively and more compassionately than the government counterparts who have taken over welfare functions throughout this century. Critics of Olasky's thesis have assailed him by comparing the litany of services and the enormous expenses of the modern welfare state to the much smaller, poorly funded private social assistance sector.

Writing as a journalist, Olasky relates contemporary accounts of private efforts to help the poor in the late nineteenth century. In his *From Mutual Aid to Welfare State*, David Beito, assistant professor of history at the University of Alabama in Tuscaloosa, continues Olasky's project. Writing as a historian,

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Bieto takes Olasky's arguments even further. He paints a vivid picture of the impact of fraternal societies in the first half of the twentieth century. Detailing the structure and activities of several fraternal orders in the United States, Beito makes the case that many of the services and activities which now fall, by default, onto the shoulders of government bodies, were once provided by these voluntary, mutual societies.

In the early part of the twentieth century, fraternal orders advocating values such as self-reliance were an integral part of American society. They provided a locus of community, particularly for immigrant and minority groups. They also provided a means of provision of social welfare services that avoided the stigma of what government charity existed at the time. Unlike government and private charity, fraternal aid was based on reciprocity. Beito writes that in fraternal orders, "Donors and recipients often came from the same, or nearly the same, walks of life; today's recipient could be tomorrow's donor, and vice versa" (p. 18).

This sense of reciprocity enabled the fraternal orders to enforce the very values that made them work well. Their oaths of membership shared common themes, advocating values like self-reliance, thrift, self-government, civility, and mutualism. These values were enforceable, and the orders held their members accountable. Members could be refused assistance because of immorality or intemperance. But the moral standards tended not to be used adversarially, since the sense of reciprocity served to remove any stigma and patronization.

What could be accomplished by these groups with strange names, moralistic oaths, and made up of immigrants, working-class people, and minority groups? Beito spends the bulk of *From Mutual Aid* describing the various impressive accomplishments of a number of these groups. (He does acknowledge that he only examines a small portion of fraternalism, but the examples he gives are representative of the larger movement.)

One way in which fraternal orders cared for members' needs was to establish orphanages for the children of deceased lodge members. While conditions in these homes were perhaps not ideal, life in a lodge orphanage was far superior to other options available for the children who lived there. Beito spends a chapter describing life at Mooseheart, the national orphanage of the Loyal Order of the Moose, located in Illinois. Mooseheart children benefited from strong discipline and character education, and Mooseheart alumni, unlike graduates of some orphanages, tended to have higher weekly wages and higher education than national averages.

More impressive than the orphanages were the medical systems formed by fraternal orders. "Lodge doctors" were employed by orders whose poor, minority, and working-class members could not otherwise afford medical care. Many in the established medical community bitterly criticized the practice. Some orders were able to build their own hospitals to care for lodge members. This was especially important in the South, where African-Americans were

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denied care or given substandard care at other hospitals. The African-American fraternal hospitals provided them with greatly improved options.

Orphanages, medical care and hospitals, life insurance, and other benefits provided poor and working-class lodge members with lifestyle options typically available only to wealthier people. By joining together in fraternal orders, these groups not only enjoyed community and fellowship, but were able to mutually improve their standard of living. The big question lurking throughout *From Mutual Aid*, is what happened to these orders? Given the obvious benefits, why do we hear so little about these kinds of orders today?

The answers are multiple and complex. Throughout the book, however, Beito alludes to a pattern of increasing government control, regulation, and competition that slowly eroded the necessity of mutual aid. As Beito points out, "The relative lack of governmental welfare spending encouraged people to form societies for mutual protection" (p. 114). Yet, services that were provided within the fraternal orders were later crowded out by government services. The president of one order said, upon the closing of their retirment home, "Social Security and other public assistance programs" had resulted in a situation where "the real need for our homes for aged members had practically ceased to exist" (p. 98).

Mutual life insurance programs, which thrived in fraternal organizations, were threatened by government-mandated compulsory old-age insurance. Following the European example, the United States moved toward substituting "paternalism for fraternalism." A growing army of social workers, social scientists, and other progressives pushed for compulsory insurance, but, in this case, the fraternal orders prevailed. However, the stage was set for later compulsory government programs that would erode the need for mutual aid.

Fraternal health care suffered its worst blows as a result of government interventions. The 1942 exemption of health insurance from the income tax caused a shift from individual and mutual health plans to employment-based health coverage. The movement toward third-party payer health coverage also hurt fraternal hospitals. As the involvement of government entities in health care grew, so did regulatory pressures. Small, fraternal hospitals found keeping up with increasingly onerous and complex regulatory standards to be prohibitive, and were forced to close. Later, Medicare and Medicaid made it possible for African-Americans to seek care in the more established white hospitals that had formerly shunned them. There were also other causes of the decline of fraternal health care, such as rapidly increasing costs in the field of health care, growth of technology, greater mobility, and migration to the north (in the case of African-American fraternal hospitals in the South), but government policies played a major role.

Describing slowing fraternal growth in the 1920s and 1930s, Beito looks again, in part, to government causes. "Societies suffered from laws that hindered their operation and subsidized competitors" (p. 205). Fraternal orders

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were subject to increasingly restrictive laws. As commercial life insurance companies grew more dominant, legislative measures that were designed ostensibly to protect fraternal orders from commercial pressures had the effect of stifling their activity. The chairman of one society complained that regulations had removed fraternalism from fraternal life insurance societies. "The fraternal has been legislated out of the plan. . . . We have too many laws that go into the minutest details" (p. 215).

The rise of the welfare state in the aftermath of the Great Depression sealed the fate of fraternal societies. Fraternalists decried the shifting emphasis of the federal government toward social welfare. The accountability, mutualism, and community associated with a fraternal order could not be replicated in any sort of government program. Government, they pointed out, is "incapable of approximating the warm handclasp from a fellow member or 'the friendly visitation of fraternalists to a stricken brother.'" One critic asked, "Is there any beautiful ritualism or human tenderness in a governmental bureaucrat?" (p. 230).

Beito is careful not to lay the entire responsibility for the decline of fraternal orders at the feet of the growing federal government. But he does make it clear that the rise of the welfare state was a major factor. In response to those who claim that the private sector, whether religious groups or mutual aid societies, cannot replace the welfare state, Beito would give a qualified response. "Mutual aid," he argues, "was a creature of necessity. Once this necessity ended, so, too, did the primary reason for the existence of fraternalism. Without the return to this necessity, any revival of mutual aid will remain limited" (p. 234).

This conclusion can be taken either as a mark of pessimism or a sign of hope. It also marks the dilemma faced by policymakers. Beito's yeoman's work of documenting the effectiveness and extent of mutual aid societies' activities rebukes those who claim that private efforts are insufficient, and should encourage those who are even now rebuilding this part of the civil order. Yet, the time it takes for mutual aid to fill any voids left by a drastically scaled-back welfare state may be too long for some. The sad truth is that the "old relationships of voluntary reciprocity and autonomy have slowly given way to paternalistic dependency" (p. 234), and that is just fine for many of those who have become dependent.

From Mutual Aid is not, nor does it intend to be, a comprehensive study demonstrating the superiority of private social welfare efforts over government programs. But Beito does provide evidence of what has been, and can be, done by private, voluntary organizations. Whether the energy and effectiveness of mutualism can be revived, or whether people will continue to demand paternalistic dependency is an open question.

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